AFFORDABLE HOUSING GOALS OF GOVERNMENT SPONSORED ENTERPRISES

ING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND COMMUNITY DEVELOPMENT

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

NOVEMBER 19, 1993

Printed for the use of the Committee on Banking, Finance and Urban Affairs

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AFFORDABLE HOUSING GOALS OF GOVERNMENT SPONSORED ENTERPRISES

FRIDAY, NOVEMBER 19, 1993

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING
AND COMMUNITY DEVELOPMENT,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry B. Gonzalez [chairman of the subcommittee] presiding.

Present: Chairman Gonzalez, Representatives Vento, Klein, Roybal-Allard, Watt, and Roukema.

Chairman GONZALEZ. The subcommittee and committee will please come to order.

This hearing is actually conducted on the basis of a full committee with subcommittee participation, although the purpose of this one is to emphasize the housing and affordable housing issue. It nevertheless will not be restricted to that. Congressman J.J. Pickle of Texas, who is a chairman of the Subcommittee on Ways and Means that has jurisdiction on his side on activities of the Government Sponsored Enterprises, will be here.

This morning is going to be a complicated one legislatively, in the full House. My understanding is that as soon as the House convenes, there will be an immediate vote on the *Journal*. Then I will present the conference report on the RTC Funding bill, which is a formality, and therefore we are going to be interrupted. But in the meanwhile we can get through some of these preliminaries.

I believe there has been some confusion in the past and internally on the committee. There had been a question of jurisdiction of this issue between two subcommittees, but it was decided that the Subcommittee on Housing and Community Development would have the preferential jurisdiction. And so it has been exercised that way.

The last attempt was made in 1981 to split off the jurisdiction of the issue, together with the jurisdiction over the S&L and the Federal Home Loan Bank Board, to the Subcommittee on Financial Institutions. Traditionally, the Subcommittee on Housing and Community Development, which until the change of its description in the 1974 Legislative Reform Act, it had simply been the Subcommittee on Housing, had jurisdiction. The Subcommittee on Housing was a preferred subcommittee, and it was the only subcommittee that had its own budget and handled as well, independ-

ently, the minority's budget on an equal basis. So there is a lot of history here so far as jurisdictional matters.

On this occasion, the subcommittee, and this expresses the concern of several very active and prominent members of the subcommittee who may or may not be able to attend this morning's hearing or will be coming in and out, is particularly concerned about the compliance with the recently published interim affordable housing goals for both the corporations we are going to hear from this morning.

We do expect that both corporations will be able to move more than fully in meeting the goals, or at least interim goals and the long-term housing goals set forth in the statute last year.

Congress established the affordable housing goals because of the previous lack of concrete information on both Freddie Mac and Fannie Mae's activity in the area of housing for low-income persons. While HUD has had regulations since the 1970's requiring that 30 percent of Fannie Mae's mortgage purchases be for low-rent, moderate-income persons, it however has not been clear that low-income persons have benefited in any substantial way from previous HUD requirements.

The subcommittee thus created specific low-income housing goals for these institutions. These goals are contained in Title XIII of the Housing and Community Development Act of 1992, which is also referred to as the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.

This statute establishes three primary low-income housing goals: 30 percent of the GSE's conventional mortgage purchases must be to finance housing for low- and moderate-income families; 30 percent of the GSE's conventional mortgage purchases must be to finance housing located in central cities; and the GSEs must purchase conventional mortgages for the specific affordable housing goals of $1.5 billion for Freddie Mac's purchases and $2 billion for Fannie Mae's purchases.

The subcommittee is also very concerned about the capital adequacy of each of these GSEs. This was expressed in the proviso in last year's law setting up the Office of Federal Housing Enterprise Oversight. We have met and in fact had a hearing, at which time we heard from the appointed head of this newly established agency that is actually set up in HUD, independent inasmuch as the statute makes it report to the Congress.

After we had passed our version in the House, we became hung up on this question of capital adequacy, particularly since both these GSEs have a line of credit with the U.S. Treasury of up to $2.25 billion. And in connection therewith, I want to place in the record at this point two articles. One is from the *San Antonio Business Journal* entitled "Laredo National investors seeking Mexican charter," and the other one is from the *San Antonio Mexico Business* entitled, "Window of Opportunity, Mexico seeks Fannie Mae to help develop its young housing market."

These articles explain how the Laredo Bank intends to set up a bank across the border and especially after the other night's vote on NAFTA, which has a special reference in these articles, which quote a Mexican Government official that he is very much in communication with Fannie Mae, and that his hope is to make Fannie

Mae a partner. The article states, "Whatever role ultimately develops, Fannie Mae's experience in mortgage lending far outpaces Mexico's." The article notes that Fannie Mae has more than a $2 billion unused line of credit from the Federal Government.

Now, apparently, one Fannie Mae official is quoted here as saying they want to cooperate, but they have to look at their charter.

[The articles referred to can be found in the appendix.]

We came perilously close to having the Reagan administration privatize the secondary mortgage institutions. In fact, the chairman of the full committee at that time was quite determined. This coincided with my becoming chairman of the subcommittee, and I withstood that.

Now, time will tell whether this was wise on my part or not, depending on what happens here. Because up to now, the institutions have had the best of two worlds.

One, the advantages of being considered private. On the other, having that edge over the private competition that having what appears to be a substantial modicum of difference in its ability to draw on the government and the Treasury.

So I wanted to express my concern with that, and want these two articles placed in the record, and we are going to distribute copies to the members.

Now, we don't want to digress from the main purpose of the hearing this morning, but it is one that we consider inextricably linked with our main purpose.

Now, the subcommittee had created and then the full committee, these capital standards to protect against any unnecessary draw from the Federal Government, and to ensure that these institutions not take unnecessary risks without adequate safety and soundness criteria.

At this point, I do want to place in the record another article, very disturbing. It appeared yesterday in *The Wall Street Journal*, entitled, "Kitchen-Sink Bonds May Offer Everything but Stability." Americans have always had a good knack of naming things, like junk bonds and so forth. Now it is kitchen-sink bonds.

[The article referred to can be found in the appendix.]

And these are what they also call CMOs. "There are," according to this article, "more than $800 billion of CMOs on the market. The problem is, a few CMOs are just too weird for investors to digest."

However, Mr. May of Freddie Mac is quoted as saying, "To the extent that this creates demand for more esoteric CMOs, the deals will improve the market overall."

Now, this is a matter of concern to myself, and one reason that I am sure Congressman Pickle wanted to be present was to inquire along these lines.

Now, we have had the bells, and I believe the second bells have been ringing, which means we must recess so we can record our vote. Since this is a vote on the *Journal*, it is a 15-minute vote, and there must be about 6 or 7 minutes left, and then immediately thereafter, as soon as the vote is announced by the Speaker, I will be recognized to present the conference report that we agreed to last night. So we will stand recessed for about some 10 to 15 minutes.

I apologize to the witnesses for this interruption, but it is one we couldn't anticipate.

[Recess.]

Chairman GONZALEZ. The subcommittee will come to order.

I apologize for the interruption. Things happen that you don't predict in this game.

Without any further ado, we will recognize Mr. Johnson. I want to thank you and Mr. Brendsel for responding to our invitation, particularly since it was rather quick notice.

Your statement as given to us in writing will be in the record exactly that way. And you may proceed as you deem best.

STATEMENT OF JAMES A. JOHNSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FEDERAL NATIONAL MORTGAGE ASSOCIATION, WASHINGTON, DC

Mr. JOHNSON. Thank you very much, Mr. Chairman.

Let me make then a reasonably short opening statement, if that would be appropriate for you. And also at the end of the opening statement, I would like to respond for just a moment to the article you mentioned about activities in Mexico. So I will turn to that as soon as I have finished some other remarks.

Let me say first, thank you again for having this hearing and giving me the opportunity to appear before you. We at Fannie Mae deeply appreciate the committee's thoughtful leadership on housing and housing finance issues in America, and your own lifelong dedication to providing decent, safe, and affordable housing for every American family.

The last time we were here, Mr. Chairman, you gave us some challenges. You raised for us and asked us to consider, and asked us to rededicate our efforts to dealing with discrimination in the mortgage finance system, and to focusing on the lack of consumer information to deal with the complexities in the mortgage finance system, and also called attention again to the problem that high closing costs and high downpayment requirements make it impossible for many people who have steady incomes and good credit histories to obtain mortgage finance.

Fannie Mae has been extremely active over the last 2 years in trying to make our programs for low- and moderate-income home buyers more effective. And I know in the written statement there is some detail on a variety of different things that we have done. But I wanted to assure you that through our Community Homebuyers Program, Fannie Mae, I work with HUD on the home equity conversion mortgage, I work with the Farmers Home Administration, I work now in moving into rehabilitation lending dealing with the developmentally disabled, and a variety of other programs, including the further enhancement of our Multifamily Program. We have made enormous progress in the last 2 years.

We began with a $10 billion commitment to do new affordable housing efforts with low- and moderate-income families, and we have been moving along now very aggressively as we completed that goal in September to expand our program, expand our outreach, and continue to work on our products to make them more and more effective.

One of the things that we have continued to do throughout this effort is to make elimination of discrimination in the mortgage finance system the highest priority for Fannie Mae. We have had seminars all over the country. We have published a new guide. We have reinforced our policies and stated them many, many times in the clearest possible way, putting our company very directly and very firmly on the side of eliminating discrimination throughout the mortgage finance system.

The hearing letter that you sent just a couple of days ago, Mr. Chairman, asks us particularly to respond to the goals the committee has established for Fannie Mae, for this year and next year and beyond. As you recall, that was quite a dynamic process in the legislation. The committee said there would be interim goals for 1993 and 1994, required the Secretary of HUD to work on those goals, to also work with us on establishing regulations affecting the special affordable housing goals, and then as we go toward 1995, in many respects there will be new additions and new formulas which will come into play since the central cities goal will be adjusted to affect also rural areas and other areas of need, the special affordable housing goal will go to a certain percent of business, so there will be a number of changes as we go along.

I want to give you a preliminary report now. Even though we have just gotten the final regulations in October of this year, I want to give you a preliminary report on what we will do in 1993 when the year is over.

On our low- and moderate-income goal, which we are expected by virtue of HUD regulations to do 30 percent this year, we expect that approximately 34 percent of our business will meet that goal. We have been working very hard, building on the foundation that we put in place, and we expect that we will fund this year approximately 1 million families who meet the definition for low- and moderate-income families.

This, incidentally, as compared with 1992, will be an increase of 220,000 low- and moderate-income families from 1992 to 1993. In the central cities area, through HUD regulations, our goal for 1993 is 28 percent. We believe that we are going to be very close to meeting that goal. There are a variety of reasons why I can't tell you for sure whether we will or won't, that I will go into in just a minute.

But once again, to give you some notion of the scale of what we are doing, in 1993, we anticipate that we will finance homes for 840,000 families living in the central city jurisdictions of the 544 central cities in the OMB list. That is up from 1992 to 1993 for central cities, that is up 180,000 families from year to year.

We also expect—once again, this is up in the air because of the nature of the regulations and some further redefinition and discussion we are having with HUD—we also expect that we will meet the special affordable housing goal for 1993–1994, and we expect that we will be well positioned to continue to meet that goal even after it increases substantially in 1995.

One other report I would like to give of a statistical nature has to do with our service to minority families. One of the things that is not in the goals of the legislation but is very important to Fannie

Mae is to make sure our continued outreach to minority families is successful.

In 1993 we expect that of the mortgages that we do, 13 percent of those will go to minority families. That will be 320,000 minority families who will be financed in 1993, and that is up 73,000 families since 1992.

So we are moving along with this process, and with these goals, building on our program of opening doors to affordable housing and also building on the instructions and requirements of the legislation of last year.

This has taught us a number of things, and I will just run through some of them briefly, because it is quite interesting for me and all of our people as we pursue our low-income lending, central city lending more aggressively.

One of the things we have discovered is that there is an enormous hunger for information among people who are renting today and who would like to move into the status of being a home buyer. We have learned a lot about working with cities and other political subdivisions. We have a new central cities cooperation initiative where we think working to the priorities of the cities and working with the city governments more directly is paying handsome benefits.

The data processing and the data collection process has been useful for us. We now know, Mr. Chairman, as a result of the committee's work, we know an enormous amount more about what is happening in the mortgage finance system. Up until this year, we didn't really have the detailed data that allowed us to tell you what we were doing in various categories. And as a result, once again, of the legislation of last year, we have sent new instructions to our lenders, and we now have dramatically higher quality data and better information about how to proceed and about who is serving whom.

One of the difficulties that we have discovered in the course of this year, one of the things that I present to the committee for your consideration, is that any time you are dealing with percent of business goals, there are issues that relate both to the numerator and the denominator. And this has been a particularly difficult year in that regard because of the level of refinances.

Almost 60 percent of our business this year has been in the refinance category. And, therefore, when you look at the work that we are doing with special programs in central cities, we find it is our experience that there is less refinance on average in central cities than there is in suburban areas.

So one of the things that is happening as a result of the percent of business goals at this time is that the denominator is growing very rapidly but we are not in a position through our special programs to grow the numerator quite as rapidly. That is one of the things I think will happen from time to time as we see the market changing.

We anticipate there will be substantially less refinancing next year, and therefore we may have a benefit in the other direction next year as we look at this percent of business process.

One of the things that we are discovering from the central city goals is that central city boundaries are drawn very differently de-

pending on where in America you are. So that central city populations, for example, in New Jersey—I just saw Congressman Klein arrive, and this I am sure will be of interest to him—but in New Jersey only 6 percent of the people live in central cities by virtue of the OMB definition. And so there are definitional questions, where if you go to North Dakota, you will find that 52 percent of the people live in central cities.

Now, by any reasonable measure no one would say North Dakota is more urbanized than New Jersey. One of the things we will have to work through here over a period of time, obviously, is how to refine the counting processes and the relationship between the percent of business goals and the political jurisdiction situation.

One other issue that has become increasingly clear to us is that there has been increasing focus on the FHA over the course of last year in that some of the areas where we have been asked to pay special attention, there is also special attention being paid by the FHA. That puts a higher premium on our having an appropriate partnership with them to make sure that as they increase their programs and we increase our programs, we work in a complementary and effective way together.

We have a number of things now that we have learned, a number of benefits that we have seen, a dramatic increase in our activity.

Let me say in closing just one word about the new regulatory environment that the committee has designed as of a year ago. We have had an opportunity on a number of occasions to meet with Ms. Alvarez. We have read her statements very closely and listened very closely as she has talked about her safety and soundness oversight. We are encouraged by her approach, we very much appreciated that dialog, and we expect based on the first stages of this that this regulatory arrangement is going to be a very instructive one from the point of view of Fannie Mae.

Now, if I might, just for a moment in conclusion, let me respond briefly to the article that you placed in the record earlier from the *San Antonio Mexico Business* publication.

One of the things that we have highlighted with the committee from time to time in the past is that Fannie Mae has assumed the responsibility or at least has decided over a period of time as a matter of policy that we should make what we have done in the United States with the mortgage finance system, in particular with the secondary mortgage market system of Fannie Mae and Freddie Mac, available on an information basis to people in foreign countries who are trying to establish a history of private ownership and an approach to home ownership finance that they believe would be constructive for their country.

As a result, over the past few years, we have done substantial advisory work in Poland, in Hungary, in Israel, in Turkey, a variety of other places, and we are now also doing that in Mexico. And it is quite true, as the article says, that a number of people in the Mexican Government have been extremely eager to visit Fannie Mae and to look at what we have done from a financing point of view.

But in many respects, the most important line of this article is—I won't count which paragraph it is in, but let me just read it to

you, because it summarizes our position. And that is, Beth Marcus of our staff says, "Fannie Mae has no plans itself to buy and sell Mexican loans, nor is it considering a charter change." And I think that is the essence of the response that I make to you this morning.

We, of course, would be very happy to receive whatever guidance from you, Mr. Chairman, and the committee that you feel would be appropriate for us in regard to making our people available to foreign governments or foreign private sector individuals about the experience that we have had in the United States, but it is not our intention to buy or sell loans in Mexico, it is not our intention to take any risk of any kind in Mexico with our financial status, and we have been continuing on the assumption that because of the success we have had, that we should continue to keep our doors open to foreign visitors as they come and to talk to them about what we have accomplished through the Fannie Mae and Freddie Mac mechanism.

As I say, I would be more than happy to go into that further if you feel it would be useful. But thank you, Mr. Chairman, for having me this morning. Thank you and the others for listening to my remarks. I am very grateful to you.

Thank you.

[The prepared statement of Mr. Johnson can be found in the appendix.]

Chairman GONZALEZ. Thank you, Mr. Johnson.

Mr. Brendsel.

STATEMENT OF LELAND C. BRENDSEL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FEDERAL HOME LOAN MORTGAGE CORPORATION, McLEAN, VA

Mr. BRENDSEL. Thank you, Mr. Chairman and members of the subcommittee. It is a pleasure, as always, to appear before you today to discuss Freddie Mac, the secondary mortgage market, and financing home ownership in this Nation.

Mr. Chairman, particularly in the course of your distinguished career on the Banking Committee, you have been a leader in supporting the extraordinary development of the secondary market which has benefited millions of low- and moderate- and middle-income Americans.

I certainly welcome the opportunity to state clearly today that Freddie Mac is strongly committed to serving our mission, and to meeting the housing goals that were recently established by HUD. I will comment later on that. We are proud of all we do and we will continue to take aggressive action to meet this Nation's housing finance needs.

Our most important next step in this regard is our reentry to the multi-family housing market. I am pleased to announce that in December we will complete our reentry into the financing of rental housing in this Nation by opening our cash window.

As you know, Mr. Chairman, the secondary market is an extremely successful component of the American finance system. It has provided a reliable and stable source of funds. It has eliminated the regional disparity and increased the availability of mortgage loans.

We purchase loans from all areas of the country, rural and urban, small cities, suburbs, large cities, inner cities, in good times and bad. Even in the face of a substantial contraction of the thrift industry over the last decade there has been no credit crunch or disruption to the availability of mortgage credit in this Nation.

The secondary market fosters an intense competition among lenders that produces innovations at every stage of the mortgage lending process, and as a result, consumers have a wide array of mortgage loans available today.

Nineteen hundred and ninety-three is going to be a record year for American homeowners and for first-time home buyers. Mortgage rates are near all-time lows, and the secondary market is bringing mortgage credit to American families on better terms than ever. The housing finance system currently is helping a massive number of homeowners refinance and reduce their mortgage payments. And it is also helping a record number of families purchase and own their first home.

I think once statistics become available about this year, it will show that once again the national home ownership rate will be on the rise.

Since our inception, Freddie Mac has been in the business of serving low- and moderate-income borrowers. This year, we will probably purchase around $50 billion in mortgage loans that have been made to low- and moderate-income Americans.

In fact, about one in four of the millions of borrowers we have served since 1970 has had an income at or below the median. But, certainly, I can only emphasize that more needs to be done. Many people are still not being served by the housing finance system. A disturbing amount of discrimination is being reported. And our country is challenged by social and economic forces that have a great impact on the housing market and on the quality of life in American communities and cities.

Employment and income patterns are shifting. There is an increasing number of self-employed and part-time workers, and America's population is becoming more diverse.

The 1980's welcomed the largest number of immigrants since the beginning of this century. These forces, these trends, challenge us to continually improve so that we can help finance housing for all deserving Americans.

We are committed to meeting the housing goals. In that regard, let me comment on current performance in 1993.

We are in the early stages, as Mr. Johnson commented, of collecting data and evaluating our performance this year. We are pleased with our progress toward meeting the goal that 28 percent of our purchases of loans be for low- and moderate-income Americans. And it appears that we have a particular challenge to meet the central cities goal.

To achieve the housing goals this year and next and the years after, we will build on what works in the current system, and we will work to make it even better. The vast majority of our affordable housing purchases will come through our regular programs, where we already reach a large number. And we will keep increasing the accessibility to those programs by evaluating policies and expanding our outreach to individuals and to lenders.

In that regard, we are working with a number of community lenders, community organizations, and people active in low-income housing and inner cities. We will capitalize on the strengths and success of the secondary market. It is a success possible because of high volume and sound underwriting principles. By aggressively pursuing this strategy, we will meet the housing goals and achieve our corporate mission.

As I stated earlier, completing our reentry to the multifamily market is the single most important step we will next take.

Three years ago, Mr. Chairman, I came to you and explained the difficulties we were having with our Multifamily Program, with cumulative losses of almost half a billion dollars. We concluded then the prudent course at that time, at the end of 1990, was to suspend our operations in the multi-family area until we had made the changes that would ensure a successful program.

At that time I set out three prerequisites for reentry to the market. One, to stabilize the portfolio of multifamily loans that we held, which amounted to roughly $10 billion. Second, to establish new programs and policies that recognized the unique nature of multifamily lending. And third, to hire an expert and knowledgeable staff with experience in the multifamily lending in inner cities.

We have met these conditions. I am pleased with the progress we have made, and I am pleased to announce to you and members of the subcommittee that Freddie Mac is back in the multifamily business.

We will work hard during the transition period to expand our knowledge of the underserved, of their needs, the needs of inner cities, and the way that the secondary market can meet those needs. We expect the results of our efforts will assist the regulator at HUD for setting appropriate goals after 1994 and measuring our performance against those goals. We certainly look forward to sharing the results of our research and what we learn with you and with the Department of Housing and Urban Development.

Finally, Mr. Chairman, let me conclude on a personal note. You have been a member of the Banking Committee for many years and you have taken a leadership role in mortgage finance and the housing system, including the creation of Freddie Mac back in 1970, and the many dramatic changes that have taken place since then.

I want to take this opportunity to thank you personally for your involvement in these issues, and especially for your support of Freddie Mac. And we look forward to working with you in the years to come.

Thank you.

[The prepared statement of Mr. Brendsel can be found in the appendix.]

Chairman GONZALEZ. Thank you very much, Mr. Brendsel. And, Mr. Johnson, you as well. I am very grateful for the very generous comments and also the honors.

I wanted to explain to you, Mr. Johnson, about your invitation of October 30. Even though it looked promising at first, there toward the end of the week, as far as the House scheduling and our notification of what would be the House schedule, the House was going through the same rather disorderly process that we now

confront today, and will be confronting over this weekend. We were meeting Saturday, Sunday, and Monday. So I found myself still trying to get away on Friday, October 29. And I couldn't, so I then did the next best thing and left on the earliest flight possible out of Washington on Saturday morning, that ordinarily would have gotten me in San Antonio at 10:30.

And this is the first chance I have had to explain this to you, because I know that you had made arrangements right in my own hometown, and actually in the middle of my district. Anyway, as luck would have it, as we got to Dallas, we had mechanical problems reported by the connecting flight, and as a result I didn't get to San Antonio until 3:00 p.m. I was supposed to have gotten there at 10:30.

But it certainly was an honor that I deeply appreciate, whether I was there to receive it or not. And I am aware, and grateful, of the expressions that you all have made.

Yes, it is true, I have been on this subcommittee as long as I have been on this committee, and that is from the beginning, 32 years ago. And I have watched, and I remember vividly the course of events, and the entirely different world and worlds that have intervened in between.

It so happens that these issues that I brought up in anticipation of the meeting are very, very troubling to me, because I think they go to the root of the dangers that are lurking there for our country as far as financial institutions are concerned, and the economic and financial freedom of our country.

I have been doing my best to try to get attention on some of these issues. Some we have had some minimum success, in others, total failure, in what I have considered the most important of all, and that is that our currency, our notes, which are really our stock in our government, has devalued. The currency has devalued on a sustained basis, which is what makes it very dangerous, in my opinion.

The reason I am saying that is because it is hard to relate that problem with what will be happening here in this area that you represent as well as ours. In the last 15 years, the dollar has lost two-thirds of its value as compared to the yen or the deutschemark. And it continues; that is, its loss of value has been on a sustained basis, and all history shows that no country can long withstand that without suffering.

Now, the thing that I feel is at risk and the reason that I have tried—and as I say, I must confess my failure—is that we are the only country that has ever had the privilege of paying its debts in its own currency. This led to General de Gaulle calling it the extreme American arrogance. With the emergence of a more stable currency, both in Germany as well as in the European community, in the European monetary system as well as its unit, the European currency unit, which now has about $1.30 value, more and more transactions are being conducted in that unit, and less and less in dollar transactions. In the meanwhile contemporaneous with this decline, which goes back really in its steepest form to the middle 1980's, it coincides with the period of time that our country became a debtor nation for the first time since 1914, and that was when

the Department of Commerce announced that fact on September 16, 1986.

Now, we have since then developed and have produced a tremendous overhang of debt, both generally, among us, the people, the corporate world, and the government. If the dollar is replaced, and I believe that there has been a clear and present danger that that is susceptible of happening, then it means that all of that debt would have to be paid in somebody else's currency.

I have had these discussions with the Chairman of the Fed, and with two members of the international banking community who seem to think that that wouldn't be possible in the immediate future unless there is instability in the United States, whatever they mean by that. When I asked them why, if the necessary nations, which would be the principal European countries and Japan, pulled their reserves, and then nationalized the unit, why, to all intents and purposes the dollar has not been replaced. Then for the first time we would have to be paying all of this horrendous debt in somebody else's currency. And in my opinion, that is the end of American economic and financial freedom and independence.

I hope I am dead wrong, but I have been concerned, and I am expressing that concern now.

Now, with reference to the articles that I put in the record, there are two articles I placed, one was entitled "Laredo National investors seeking Mexican charter," and the other was "Window of Opportunity, Mexico seeks Fannie Mae to help develop its young housing market." It is more than experience and advice, that apparently they are seeking.

As a matter of fact, it is something that we worked with on this subcommittee, when we had the first opportunity to pinpoint the fact that the so-called free trade agreement contained just about 10 percent trade, and the rest something else, and it had a chapter that was not mentioned until we called a hearing on September 9, on chapter 14, the banking and financial section of so-called NAFTA.

That plus other provisions in another chapter on securities, which, of course, belongs to another committee's jurisdiction, but they did not exercise it. As far as I know, we were the first and only committee to really have hearings on those sections that have pertinence to its jurisdiction. We had three hearings that were not reported, that were not covered. We were blacked out, and that is not for me to judge one way or the other, other than the fact that the agreement was put together in absolute secrecy. Try as we will, we have never been able to get any kind of minutes or transcript or record other than the pledge which was finally complied with about 2 weeks ago from the Assistant Secretary of the Treasury that was involved in that chapter 14.

And in answer to my question, the Assistant Secretary said, yes, that he had been the leader in that, but that they had had the involvement of many, many others. So when I asked him to give me the list of those other individuals, he finally did, 2 weeks ago, and they were all the principal megabank lawyers and officials. Now, you can take it from there.

In this article entitled "Window of Opportunity," obviously this official is doing more than seeking advice. Mr. Karg says, "While

no decisions have been finalized, several options are under discussion. One is an investment to be made by Fannie Mae in the entity the government would charter to operate the secondary market." Meanwhile, in another section the Mexican Government is seeking permission to set up a secondary market arrangement, patterned on the American experience.

But they are looking for more than just advice. And we brought that up during our hearings, because the potential for this is greater than would meet the eye. Here, the ink on the NAFTA, as far as the House part, still hasn't dried, and we have already got indications of the fallout that we had observed during our hearings. And it is in this area.

Now, I want to point out, just as a matter of immediate observation, that section 304 of the National Housing Act requires Fannie Mae in its operations to confine its activities to mortgages which meet minimum creditworthiness standards. The committee during our hearings, three hearings, heard numerous witnesses, and we adduced substantial documentation, showing that the dangers of investing and doing business in Mexico were very great.

I would say that this is true. If Fannie Mae or Freddie Mac, for that matter, was to invest in or to provide liquidity to the Mexican mortgage market, it would be inconsistent with its charter of purpose and authority, and it would be necessary to seek that authority from the Congress. I believe it would be entering a very risky field.

And with that, I am going to cut off with this other article on the kitchen-sink bonds. It is very disturbing, because, Mr. Johnson, you said that 60 percent in the immediate past involved refinancing, because of low interest rates.

Now, I don't know what percentage Freddie Mac would report, if you have——

Mr. BRENDSEL. It would be about the same.

Chairman GONZALEZ. About the same.

My question is, given the instability and the lack of any kind of a control on interest rates, what would happen if you had an increase in interest rates in the near future? What impact would that have on all of this refinancing restructuring?

Mr. JOHNSON. The impact on the refinancing would be to largely bring it to a halt. We have had two very big refinance years in 1992, 1993. There were very big refinance years in 1986 and 1987. But if you look at those intervening years of 1988, 1989, 1990, 1991, Leland might have an exact number, I don't have an exact number in mind, but my guess is that the refinance number would be down to maybe a quarter or even 20 percent of the rate that it was this past year.

So what happens is that the refinance comes when the interest rates go down, when the interest rates level out, and people then more or less have gotten down to the new low-interest rate environment, there is no further incentive to refinance. So it goes very quiet for a period of time.

And then if rates go down again substantially for people who during the intervening period took higher interest rate mortgages, they refinance again, and it kind of goes in a cycle. But our expectation for next year, for example, is that the percentage of the

loans that we deal with that will be refinances will probably be down in the 25 percent range, roughly, from a high of 60 percent this year.

This is the highest year we have ever had, Mr. Chairman.

Chairman GONZALEZ. Mr. Brendsel, do you have any comment?

Mr. BRENDSEL. That reflects our own thinking. We expect next year, by the way, the percent of loans we purchase for refinancing will probably be in the neighborhood of 30 percent or so. What that really reflects is some small differences between Mr. Johnson and myself about where we think interest rates will be next year.

If interest rates stay low, more homeowners will have an opportunity to take advantage of that by refinancing their mortgages and reducing their mortgage payments.

Mr. JOHNSON. Might I just add one thing?

I had some statistics done recently as to the effect on the total mortgage cost of American homeowners as a result of this refinancing and interest rate adjustment period that we have been in in the last 2 years. And our chief economist at least, Mr. Chairman—I don't know whether this is exactly accurate or whether other economists would agree precisely—estimates there has been about a $30 billion reduction in the past 2 years of the amount of money that individual home buyers are paying on their mortgages as compared with the beginning of this 2-year period.

So that there is an economic stimulative effect of putting more money in people's pockets, so that they have that money either for savings or for other uses as a result of this change in the interest rate environment on mortgages.

I just point that out to you as a number that at least can help us partially size the situation.

Chairman GONZALEZ. If you were to have a return, gradual or not, to a higher interest environment, what is the exposure of the institutions as a result of the refinancing, if any?

Mr. JOHNSON. There really isn't any exposure that flows to us from that, because we fund our portfolio in such a way that when we do fund, we put a liability on our books to match the mortgage assets that we have, that structure is put in place for the duration of the mortgage in question. So if the mortgage is a long mortgage, it lasts for the duration of a long mortgage.

We now have a substantial amount of callable debt, so if it is a short mortgage, there is a rapid payoff, we can also call the debt. So we continue to have a well-matched book of assets and liabilities in part because of this innovation over the last 3 or 4 years of callable debt.

So that, you know, from an asset liability or interest rate exposure point of view, there is nothing about the turning down of the volume of refinance activity that would affect our financial wellbeing.

Chairman GONZALEZ. The article in *The Wall Street Journal* yesterday was bothersome to me because, as described in the article, "The bonds are issued by trusts into which Wall Street dumps bits and pieces of capricious, hard-to-value mortgage-backed securities. If the market for a certain mercurial mortgage-backed bond should dry up, just pop it into a trust and get it off the investor's books."

Now, apparently the problem with these bonds, and apparently some Federal regulators are worried about it, is that they are so complex that their actual security and profitability are difficult to analyze.

Now, the article also intimates, if it doesn't actually—I believe it does state, Mr. Brendsel, that Freddie Mac is considering issuing kitchen-sink bonds, even though a vice president with Freddie Mac is quoted as expressing serious concerns about these bonds.

Now, what I am trying to figure out is, if it is done, what accommodation could be found with respect to the application of the critical and amenable capital requirements. As you state in your testimony, Mr. Brendsel to meet critical capital requirements, Freddie Mac must hold 1.5 percent capital for on balance sheet assets, and 0.25 percent capital for off balance sheet assets, and also to meet minimum capital requirements, you must hold 2.5 percent capital for the on balance sheet assets and forty-five one-hundreths of 1 percent capital for the off balance sheet assets.

So what would this investment and this type of bond be? Off balance sheet?

Mr. BRENDSEL. First of all, we do not invest in those types of securities referred to in the article.

Second, as I think the article correctly pointed out, the particular type they were talking about, we do not issue those securities either.

Nevertheless, the capital requirements—the very innovative capital requirements that are included in this legislation that this subcommittee labored long over—both the minimum and critical capital requirements as well as, more importantly, the risk-based capital requirements, would take into consideration what is both on and off our balance sheet, which might be these, if we invest in them, they would be taken into consideration by virtue of applying that capital standard. All of those risk characteristics are taken into account in the risk-based capital standards embodied in the legislation.

But let me emphasize again, we don't invest in those types of securities, and neither do we issue them.

Chairman GONZALEZ. Your intention is not to go into them?

Mr. BRENDSEL. The answer is yes, our intention is not to issue those kinds of securities.

Chairman GONZALEZ. Well, I am glad to hear that, because we seem to be entering a decade of gambling in the commercial banking era, more than banking. And it has been a matter of extreme concern.

The principal 20 banks of the United States, commercial banks, have tremendous off balance sheet disjointive activities. The off balance sheet covers everything, obviously, from some not too risky to the extreme risky derivatives, and there is a zillion of those, international currency futures, and that is gambling, in my book.

But one of the banks, one of the principal banks, has had a very high percent off balance sheet compared to its national capitalization structure. That seems to me to be a very, very dangerous market. Then you go down the list on the 20, and I see what is very disturbing.

So I say that every effort should be made, even as some desperate situations may arise in the future, to stay away from these rather risky or questionable, as far as value is concerned, investments.

Well, thank you very much.

Mr. BRENDSEL. Mr. Chairman, let me make a couple of additional comments about the article. The first one, of course, is that in general, what has happened in the mortgage-backed securities market over the last 10 years has been a major innovation in the types of mortgage-backed securities that are issued, the so-called multiclass securities, or the CMOs. That has brought tremendous benefit, not only to investors, because it has enabled them to invest in a sound way, that they can manage their portfolios, but also has resulted in tremendous benefit to American home buyers by reducing mortgage rates, by bringing more investors into this market.

We certainly continue to issue multiclass securities very aggressively. The particular practices that were mentioned in this article really refer to matters of disclosure practices, the characteristics of these securities, and then how were they sold. And in that regard, it was referring to the so-called private label market, that is, the securities that are not issued by Freddie Mac or Fannie Mae.

Freddie Mac and Fannie Mae have been leaders in disclosing information about the types of securities that we issue and the mortgages that back those securities. In fact, we go beyond SEC requirements. Even though we are exempt from those particular requirements, we recognize it is very important to give investors the quality information they need to evaluate their investment.

With regard to selling practices, we, of course, don't sell directly to investors. It is generally done through securities dealers.

In that regard, I think there has been some information to indicate, and I think it is alluded to in the article, that in some cases securities are sold by unscrupulous salespeople that don't provide the right kind of information to investors. In that regard the Government Securities Act, I believe, recently tightened up some requirements in this area, suitability requirements and so forth, which we absolutely think is the right way to go, because what we want to do is ensure the integrity of this market for all involved, and specifically for American home buyers.

Chairman GONZALEZ. Very good. Well, I deeply appreciate that. All in all, I want to compliment both of you gentlemen for the operations.

Mrs. Roukema.

Mrs. ROUKEMA. I would be perfectly—all right, you are a gentleman and a scholar. Thank you, sir. I thank my colleague from Minnesota as well.

I would ask, Mr. Chairman, unanimous consent to include my introductory statement in the record.

Chairman GONZALEZ. Without objection, so ordered.

[The prepared statement of Mrs. Roukema can be found in the appendix.]

Mrs. ROUKEMA. I do beg the forgiveness of our two guests here, our two panelists here, for my tardiness. It was unavoidable, but I have got to say, particularly to Mr. Johnson, this is the second time in a week I have had to express a regret at not being able

to be present when Fannie Mae had offered me a wonderful opportunity a week ago to speak to a group in Saddlebrook, New Jersey, on this subject.

I want to express my appreciation for Fannie Mae's interest and for the initiation of your work in New Jersey. It is very fine.

Not having heard your testimony, however, I have been briefed on it. I do have a question for you, or a question or two for you. It is a little different—the second will come back in a sense to what the chairman has been asking, but let me ask you about your central cities goal.

I understand that in your testimony you have made a point of saying that the mortgage financing, the standards presently set up under the regs as you understand them would provide more central city financing, if I understood correctly, in North Dakota than in New Jersey.

Whether or not that is the specific case, Mr. Johnson, could you explain to me more the problems that you have with the definitions or perhaps we should review with those definitions if, for example, in a place like my district, we would qualify for no funds, or—and statewide, a State that is as urban as ours, it seems that there must be something very distorted in the definition if it has that consequence. And would you have recommendations for what we should do about it?

Mr. JOHNSON. Thanks very much for the question. We had a very good session, I should say, earlier this week up in New Jersey, and we are sorry your schedule didn't permit you to participate.

I should say, first of all, that from the very first time the committee considered central city goals and low- and moderate-income goals, Fannie Mae was supportive of that concept. So this is in no way to suggest that we should not have goals in terms of serving important priorities of the Congress. And I don't want to have any implication of that sort left behind.

But as we have now moved through this first year, and I said a little bit about this in my opening remarks, we are learning a lot, and I think HUD is learning a lot and everybody else is beginning to focus on issues that the committee had no way of anticipating necessarily when this legislation was passed a year ago.

Central city definitions in fact are monitored very closely by the Office of Management and Budget. And there is a list of 544 central cities, which as a matter of fact even changes each year, which is one of the difficulties we have at the moment, because we have just gotten the changes for 1993, and therefore when we try to calculate whether or not we are meeting the central city goals for most of the year, we have had to operate on the 1992 list of central cities rather than the 1993 list.

Mrs. ROUKEMA. Excuse me. You mean to tell me you are dealing with a constantly moving target? Is that what you are saying?

Mr. JOHNSON. Yes. Very much so. Very much so. It is also the case that as we work with these targets, we are learning a lot about the way they affect various populations in various States. So I made a comment earlier that I thought that 6 percent of the mortgages made in New Jersey were eligible for central city treatment or counting in the counting as it has been designed by the OMB list, and that there were 52 percent in North Dakota.

For purposes of clarifying the record, one of the Fannie Mae people with me this morning was kind enough to say that the actual central cities score eligibility is 5 percent in New Jersey and 64 percent in North Dakota.

So that what we have is a situation here where—and the committee anticipated this to some extent, because the committee said that after this interim year of 1993–1994, that it was the responsibility of the Department of Housing and Urban Development to adjust this goal to central cities and, quote, "other underserved areas," so that we are in an interim period here where we are beginning to learn something about how this is all going to work.

But one of the things that happened historically, and you may all be more familiar with this than I am, but as a metropolitan organization moved from east to west, basically the lesson that was learned was if the central city could have a larger jurisdiction, there would be advantages in terms of annexation, advantages in terms of the management of the area. In States such as New Jersey, where the county and township structure was put in place very early, before these lessons were learned, municipalities tend to be much smaller than in areas settled later.

And so it has nothing to do with the income characteristics or racial characteristics or anything else of the people of New Jersey. What it has to do with is the history of municipal organization, essentially.

So what we find is west of the Mississippi, many, many of the States have extremely high percentages of people who live in central cities. I don't know for sure that this is accurate, but as we began to look into this, one of the people at Fannie Mae mentioned to me that the central city of Albuquerque is 200 miles from one side to the other. As you well know, there are no central city jurisdictions in New Jersey that have that substantial geographical coverage.

So what we are trying to do is really a combination of things; that is, that we are trying to move forward with the full range of our outreach programs, and we are doing more and more central city agreements, more and more targeting of our focus. We have now made all central cities eligible under our so-called Fannie Neighbors Program, where we have introduced a number of our lower downpayment mortgages and our higher approval, more flexible mortgages into the whole of the central city rather than just part of it by virtue of income characteristics.

So this will be changing, evolving, moving along, and I think we certainly know that by roughly a year from now, this will be fully taken into account under the phrase of "other underserved areas."

What we are trying to do in the interim is continue to learn as much as we can how it works, and then as we go through 1994, I would expect in our dialog with HUD, there would be a refinement of these targeting requirements.

Mrs. ROUKEMA. So you feel that the present statute gives you the flexibility and the latitude you need to deal with it more realistically?

And, of course, if not, then that shows why this oversight hearing is so well determined here by the chairman, because we will be looking forward to any precise recommendations you can make, and

I would hope you could do it within the existing statute. If not—we are here to serve you.

Mr. JOHNSON. I think we can do very nicely with the existing statute.

One of the other things I have tried to make clear to the chairman and the committee as we have gone along here, over my 3 years of service as Fannie Mae's CEO, is that we are trying very hard not to take any kind of mechanistic view of the committee's instruction really that we be more active in affordable housing.

So we have a wide variety of outreach programs, for example, that don't count at all in any of the percent of business goals that we have. We have programs for the developmentally disabled, we have some AIDS housing programs we are working on now, we have a variety of other things we are doing with State housing finance agencies, with the low-income tax credit investments. We have a very large number of things that are not countable. But it seems to me that the general admonition of the committee has been for us to use our resources to have a more important effect on all aspects of the smooth functioning of the mortgage finance system.

So that is what we are doing. And, therefore, I don't believe that we need any statutory adjustment.

Mrs. ROUKEMA. It is not going to be at the expense of your low- and moderate-income housing projects?

Mr. JOHNSON. No, it is not.

Mrs. ROUKEMA. I should like to make a point, and I don't know if you want to comment further on this, that I think we all want to be assured that the housing priorities do not conflict with the safety and soundness requirements under the law. And I would like to have the assurance—it is a rhetorical question, really—that we—that you should feel the obligation to completely inform us should you feel that at any point in time the two are in conflict, and certainly we want—I, for one, want safety and soundness to be the highest priority. It is a rhetorical question.

Mr. Brendsel, would you like to comment?

Mr. BRENDSEL. Only by saying that no borrower wants to default on their home. The last thing that they want or that a neighborhood in which that home was located wants, is to have a loan default. Obviously, that also results in a loss to investors.

We believe that financing affordable housing, helping people buy homes, lower income minorities as well as middle income, is totally consistent with the safety and soundness requirements.

Mrs. ROUKEMA. That is true, but we all know the statistics, and the growing number of the defaults. It is a tragedy, but we want to work with these people, of course, but we don't want it to be at the expense of the safety and soundness standards that we have set up.

Thank you very much.

Chairman GONZALEZ. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

I read both of the statements and appreciate the oral comments. In terms of the packaging of loans and so forth, I mean, the fact is that as you are packaging central city and other types of loans

that are part of the goal, they become packaged with loans on a broader geographical basis, isn't that correct, Mr. Johnson?

Mr. JOHNSON. Yes, it is.

Mr. VENTO. So the fundamental question of safety and soundness, I suppose really relates to whether or not that bond gets sold or not.

Mr. JOHNSON. Well, the fundamental question for safety and soundness for Fannie Mae—certainly that is one of the dimensions. There are two or three others we have to keep our eye on as well. One is the default rate and the delinquency rate and the foreclosure rate, and how much we charge off for credit losses. We watch that very carefully, as you might expect.

A second category we have talked about so many times with the committee is our management of interest rate risk. Because of the size of the portfolio we have, I believe that we have the most sophisticated interest rate risk management operation that exists.

We also have some operations and systems risks that we have to pay a lot of attention to. As a matter of fact, the capital requirements that you passed last year have a specific override in terms of increased capital being required to make sure that operations and systems risks are covered.

And this year, as I mentioned in my written testimony, we will do $300 billion of total business, and as you can imagine with that, we have hundreds of billions of dollars flowing through our company, and it is extremely important that we do all of that right and not expose ourselves to any risk in that area as well.

Mr. VENTO. The issue that I was interested in was your point in your testimony, picking up on the refinancing issue, and a significant amount of refinancing. Now, when you are expressing the amount of paper sold this year, is that really much of that? When you say 60 percent of it is refinancing, is that really recognizing 60 percent of that paper as refinancing or resold paper? How do you treat that for the statistics that we have before us?

You gave some numbers in your testimony about serving 3 million families.

Mr. JOHNSON. We have been instructed now through the regulations which came out on October 13 to assemble our statistics, including both purchase mortgages and new mortgages and refinanced mortgages together in terms of the satisfaction of these numbers.

I mean, it is interesting to note, if you ask me, will we meet our central cities goal excluding refinancing, I would say, yes, we will. But with the level of refinancing going on, particularly outside of central cities, we have this numerator-denominator problem.

Mr. VENTO. That is what I was referring to. So the numbers we are looking at on page 2 of your statement, $300 billion, 3 million families, my question really is, does that include—that does include, apparently, the refinancing paper, is that right?

Mr. JOHNSON. Yes, it does.

Mr. VENTO. So you are extinguishing some paper. So if it is 16 percent, it would mean $180 billion of that is refinancing.

Mr. JOHNSON. Yes.

Mr. VENTO. Mr. Brendsel, I didn't see your numbers here, but can you just give them to us? You said yours was also about 60 percent.

Mr. BRENDSEL. Yes. Somewhat more, but close to it. We will purchase a little over $200 billion of mortgages this year, $220 billion. And again, that is total, that includes refinancing and purchase-money mortgages.

Mr. VENTO. It is no secret to us, interest rates are down and the economy isn't getting the type of bounce that it should be in terms of housing construction. If you are out there buying in some markets, it is still very good because you can get low interest rates, if you had a mortgage. But I think this sort of speaks to the problems.

And, of course, the other aspect, Mr. Chairman, which in terms of refinancing, which Mr. Johnson points out, is that because of the decline in housing price in a few parts of the country, some families have been unable to take advantage of lower interest rates through refinancing. I just would like you to elaborate a little bit on that.

I think we get a better view from the secondary market programs of the nature of the pent-up demand in terms of the depressed or the lack of appreciation or the depreciation in terms of housing.

Mr. Johnson.

Mr. JOHNSON. Sure. One of the things I mentioned we are trying to deal with and we announced a change in our policy today is that in some areas where housing prices have gone down—and I must say, if you look at the last 2 or 3 years, on a national statistical basis, there are not that many—but if you look at the areas where they have gone down, one of the things that happens is that as the value of the home goes down, people become ineligible for refinance, and therefore they are in a strange situation, often, because going down in the home value normally also means you have a softening of the job market and you have other economic problems that are under way.

Then you have a situation that because of the loss of equity in a home, they must maintain their payments at the higher interest rate, because they are not eligible for refinance. So that one of the things that we are announcing today is that we are going to try to deal at least with part of that problem by allowing people to refinance up to 95 percent of the value of their home, and previous to today, we allowed only 90 percent.

Now, this will have an effect certainly in California, which we are very sensitive about because it is a very difficult economic situation in California. It should have some effect probably in Massachusetts, where there has been some downward pressure, probably some in New York, New Jersey. So it is very hard to calculate how many families will be affected.

But one of the things we are trying to do and we believe it is prudent in terms of our risk exposure, is to increase the availability of the refinancing option to people who had previously not been able to refinance.

Chairman GONZALEZ. If you would yield to me on that, because that is the area of the so-called underwater mortgages, and I just ask to intervene because Congressman Kennedy is very much involved in addressing this problem, which seems to be acute in the

Boston area, and has asked that we hold hearings in Boston in December, which we intend to honor his request. But, apparently, you have described it very well, and these areas are the areas mostly adversely affected, by finding themselves in this very difficult situation.

Mr. VENTO. No, I agree. And, of course, 95 percent is an improvement, but clearly the real problem is, if you have got a high interest rate risk of 10 or 11 percent on a mortgage that may only—or a price now that may only be 75 percent in a 95 percent mortgage, it is a real dilemma. Do you actually improve the performance of the mortgage by lowering the interest rates and borrowing the money over and above the amount, or do you not? It is a real dilemma.

Of course, ironically, many people don't realize the value changes in terms of property until they come in to refinance, which is when the bad news comes.

But, you know, the reason, Mr. Chairman, and our witnesses, this really is, in essence, the issue where troubled markets exist often in cities and sometimes in other communities in trying to get the secondary market involved, which is really the response in terms of establishing credit.

For instance, I was surprised in my community to realize that there were some condominiums in the downtown area that were owner-occupied, the buildings were largely owner-occupied, and they still couldn't refinance them. And the banks, of course, were pointing to the secondary market as not being available. And it may be an education problem, it may be a lack of information.

I did note in your testimony, Mr. Brendsel, and I know that Mr. Johnson probably has the same thing, that you are talking about improving underwriting guidelines on page 10, the underwriters' barriers outreach group you put together. Do you want to explain to me how that could work. I understand there may be legitimate concerns about condominiums. That especially in central cities that were overbuilt on some of these, they are empty, and even if they are owner-occupied, represent problems, so I don't take it in any way as an assumption that you are willing to fund these or unwilling to fund them.

But I did want to point this out, because, Mr. Chairman, if we are ever going to get housing markets in cities to go—there is a whole phenomenon that takes, you don't have liquidity to operate, it encourages absentee landlords, it encourages a downward spiral where you can't get your equity out, and it creates havoc in these troubled communities. I wouldn't say they are all central cities, either.

Mr. Brendsel.

Mr. BRENDSEL. As you point out, Congressman Vento, the importance of having the right underwriting guidelines is critical, not only for Freddie Mac or Fannie Mae but also for the communities and the borrowers that are being served by lenders that sell mortgages to us. So we take having the right underwriting guidelines very seriously, and ensuring that lenders use them in the appropriate way.

One of our major goals, a continuing goal is to ensure that our underwriting guidelines create no barrier that keeps a deserving homeowner from taking on a mortgage loan to purchase a home.

In fact, after hearing what were very disturbing comments to me made by a few lenders and other organizations back in the late 1980's, in fact, by a few Members of Congress, members of this subcommittee, about how our underwriting guidelines might create unnecessary barriers, we commissioned a special study, a very extensive study in 1990, by retaining a consulting firm, to assist us in that regard. We subsequently undertook a project to completely review our underwriting guidelines, and in doing that, we brought in community lenders and community organizations, and really went through the guidelines with a fine-tooth comb. We surveyed many, many lenders across the country, held focus groups, to examine how the guidelines could be improved and where there were problems.

The result of all that, and we submitted—I think we provided a copy of that report and study to members of this subcommittee in 1991, we made some significant changes to our underwriting guidelines, improvements, I would say, both in terms of clarifying how they were to be applied, understanding for lenders, as well as in some cases changing those requirements.

Just to give you one example, probably appropriate to inner cities, so-called requirements for mixed-use neighborhoods. We will buy a mortgaged loan on a home where you have got a store sitting next door. The answer is absolutely yes. We wanted to ensure that that was understood by lenders and that was clear in our underwriting requirements.

And it was those kinds of changes and clarifications that we undertook. And this is now an ongoing process. Every year we hold something called an Underwriting Barriers Outreach Group where we pull together lenders, community organizations, and we examine what has changed since the last time we did this, what did we learn about how the process works, what can our lenders tell us.

And we are now going through the next round, and I expect there will be some additional clarifications, and changes in that regard. The objective is to always keep the guidelines up to date and appropriate to the Nation and its communities.

Mr. VENTO. I couldn't help but think, I know Mr. Johnson probably wants a chance to comment, but as Mr. Brendsel was speaking, as so often in the past when there was no national market, we didn't have national standards. You had a niche in a financial institution making a decision, understanding the market, converting this to national standards and we lose some of the ability to deal with the type of needs of a troubled market specifically.

Mr. Johnson.

Mr. BRENDSEL. Excuse me, I think that is one of the misunderstandings about the underwriting guidelines, both of Freddie Mac and, I will represent, of Mr. Johnson's guidelines at Fannie Mae.

In fact, what you have is really the best of both worlds; some general standards, standardization about the terms, for example, about documents, about general approaches. But then within that, by working with our lenders, training them, providing additional guidance to them, they can tailor those general guidelines to their

local communities and to their local needs. And it gives them the flexibility.

Now, that is—I said it was the best of both worlds—that is much better than the old system. In years past, before the secondary market, you had each lender developing their own guidelines. Sometimes they would serve the needs of those communities but many times they would not, and as a result you had significant pockets of underserved borrowers within those communities, and at the same time you weren't able to get the efficiencies in the lending process that result in lower mortgage rates.

Mr. JOHNSON. I just have a very brief comment. One, we have changed our underwriting standards 30 times in the last 4½ years to try to become more responsive and more flexible and try to be more attentive to the needs of particular groups.

I guess I disagree a little bit with my colleague here, Mr. Brendsel, on the second point, and that is that I continue to view the appropriate introduction of flexibility into the national mortgage finance system as a challenge for all of us. I mean, we are extremely focused now on being attentive to the problems you are talking about, but we work through 3,000 lenders, all of whom are interpreting our standards. They are working in turn with millions of people as individual borrowers, and, you know, thousands of people in the context of multifamily projects. So there is a lot of tension going on up and down the system.

And as you recall, one of the things that the Boston Fed study said last year was that many loan officers were not inclined to exercise the flexibility that was given to them by the secondary market. And so while what Leland says is absolutely right in terms of filling gaps and also setting a lot of standards, I think we, and I guess everybody else in the system, still have a flexibility, adaptability challenge which throughout our whole organizations I think will be with us probably forever, but it is something we have got to keep our attention on.

Mr. VENTO. I know Mr. Watt has been waiting, Mr. Chairman, but I did want to comment, I did note your concerns about meeting the goals as set forth by the Secretary in terms of the urban area, Mr. Brendsel, and the numerator-denominator concern that Mr. Johnson pointed out to us with regards to the refinancing included in the dilemma that that makes, but nevertheless I think that it is in fact dynamic. And I take it that you are attempting to continue, when we talk about substituting counseling for equity. I look at my friends working in historic preservation and finding out that taking care of a home, when it is way over the value amount and yet has some very important considerations in a community, plus I think the important programs of the moderate-income housing finance programs to deal with cities so that you don't have to go to the suburb to get a $200,000 loan but you can do it in our communities, St. Paul and Minneapolis area.

So I appreciate the efforts you continue to work at these goals, and we obviously need to continue to understand what the problems and dilemmas are, because of the tremendous importance of this market in really dealing with the problems that troubled communities are experiencing, continue to experience in the 1990's.

I am also concerned, incidentally, about this home equity loan phenomenon and what the impact of that is on refinancing and some of the other aspects you are working with. So we can talk about that later, but I don't want to prevail any longer on the chairman or on Mr. Watt's time.

Thank you, Mr. Chairman.

Chairman GONZALEZ. Thank you, sir.

Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

Thank you, Mr. Vento, for yielding to me, at least saving me a little bit of time here.

Mr. Chairman, they say a little knowledge is a dangerous thing, and sometimes you have to ask some questions to get even to the point where you have a little knowledge. And I have some questions, some specific questions, but I can't resist the temptation to kind of pick up on one point that Mrs. Roukema started, and Mr. Brendsel responded in a way that surprised me, I suppose.

Maybe it reflects my lack of knowledge or the little knowledge that I have about how these secondary market operations or GSEs work. But I had always thought that the purpose of these two GSEs was to deal in mortgages with higher risk. I mean, I thought that was one of the underlying purposes.

And it seems to me that if that is a purpose, and if a purpose is also safety and soundness, as Mrs. Roukema suggests that it is, to say that those two things are not in conflict with each other, maybe constructive conflict, but certainly conflict nevertheless, is to be less than honest with us.

And then I would add a third element that goes beyond safety and soundness, and then I will allow both of you to address this kind of general philosophical question, and that has to do with the element of return to your shareholders, which seems to me to go a little beyond safety and soundness. I mean, safety and soundness is one thing, but making sure that you maximize your return to your shareholders goes beyond safety and soundness, and seems that that third thing puts an even greater tension into the equation and the balancing act that you are required to do.

I guess my question is, maybe, Mr. Brendsel, whether you are sincere with us when you say you don't see those things as being in conflict with each other, or maybe I misunderstood what you were saying.

Mr. BRENDSEL. Maybe I wasn't clear, Mr. Watt. Maybe I didn't explain myself with the right choice of words that I should have.

You begin with the phrase a little knowledge is a dangerous thing. In listening to your question, I don't think that reflects just a little knowledge about the kind of fundamental and important issues to talk about when we talk about companies like Freddie Mac or Fannie Mae, which are government chartered, for a purpose. It is the purpose of increasing the availability of mortgage money for people to buy homes or for rental housing in this Nation, in a safe and sound way. It is really so we can improve the quality of life of Americans in this Nation.

Now, I said a couple of other things when I commented earlier, but I don't believe they are in conflict. I think I could accept the modification of a constructive kind of tension. But having someone

be able to get a loan that they can afford to make the payments on is not just important to us, but it is very much important to the home buyer, who is taking out the loan. There is also the importance of making a sound, multifamily loan to a responsible owner that we think is soundly underwritten so that the owner will, over a reasonable set of economic conditions, be able to maintain that property and make the mortgage payment. Not only is it important to us as an investor but also it is important to the tenants in that building.

I made reference earlier in my remarks today about our experiences in the Multifamily Program. I have been through many, many, many apartment buildings in inner cities that we have financed where the landlord, the owner became distressed and the first one to feel the impact of that, even before Freddie Mac feels the impact from the loss on that mortgage loan, are the tenants that live in that building.

So to have soundly written loans that the borrower, whether the home buyer or the owner of an apartment building, can afford to repay, is in our interest as an investor and also in the interest of home buyers and renters.

Let me go to one additional comment on part of the question that you posed, and that is, absolutely, it is the responsibility of Freddie Mac to use every ounce of effort that we have to find ways to buy every mortgage loan that we can purchase, that we think is investment quality, that the borrower has a good chance of being able to repay. And our commitment to that goes beyond what you would find in a private company, not chartered by Congress, and we devote enormous resources to that.

And you can call that taking additional risk. I call it taking additional effort to understand how to make those mortgage loans, how to buy those mortgage loans.

Mr. JOHNSON. Congressman, I think you have identified one of the most fundamental questions facing our company, and that involves the ongoing balance between the fulfillment of our housing mission, the safety and soundness required by the committee and now enforced by the regulator, and the appropriate return to our shareholders to ensure that the number one objective, when we were created, continues to be true, and that is, we were created because the Congress wanted to have open-ended access to the capital markets for the funding of housing, and wanted that open-ended access to be organized in such a way that there would be no ceiling on the amount of mortgage money we could provide, so at any given time, whether it be recession, or difficult times in one part of the country, we would continue to come forward with the mortgage money.

One of the reasons we are very attentive to the level of return is that we want to be able to go to the capital markets at any time to raise additional funds. The years 1992–1993 are very important examples in that regard, where because of that surge of activity in mortgage making, we have had to use virtually all the capital at our disposal in order to continue to grow during this period and continue to provide that function.

Had we had less capital on our books, had we had fewer profits, if you will, over the last few years, in the course of a year like

1993, we could very well have come to a screeching halt in terms of our ability to provide the financing around the country that we do.

Let me just say one other word about the housing mission and risk. It is something that we try to balance in a lot of different ways. The chairman earlier pointed out today section 304 of the National Housing Act, which requires us to deal with investment grade mortgages, and to be very attentive to the quality of the mortgages that we deal with.

Now, even in that context, I have just been at Fannie Mae for a little less than 4 years, but since I have been there, through the foreclosure process, we have charged off about $1 billion of losses.

Now, we are very prudent in how we go about making mortgages, we are very prudent about our capital levels, we are very attentive to the returns, but even with all of that in the 3¾ quarters years I have been at Fannie Mae, we have had to charge off about $1 billion of losses, because of underwriting mistakes that have been made in the system that exists today.

So we take a lot of risk. We also have a big housing responsibility. And we have the ongoing organizational responsibility to be safe and sound and maintain our access to the capital markets.

So you are at the crux of the most important management challenge that we face, and we address this, I address this at virtually every board meeting with our outside directors. It is something that we spend endless management retreats focused on, as to what the appropriate level of housing risk is, the appropriate safety and soundness. So you are right at the core of what we are doing and thinking about.

Mr. WATT. I would have to say I guess that is why I was surprised at the response that I thought I heard the first time around to this question, that there is not this tension that is always there. It seems to me the only way this thing ever worked is that there is a tension between greater risk, safety and soundness, and investor return, otherwise—I mean, the process simply won't work.

I appreciate you all articulating it so that I understand it better. I thought I had somewhat of a knowledge, but it helped me just to hear both of you walk us through that.

And I would say to Mrs. Roukema, I think we have got to continue to push not only for safety and soundness, and I don't mean to suggest by any stretch of the imagination that we ought to sacrifice safety and soundness, and I understand better now the need to also be attentive to the return on investment aspect in light of what you have said.

Mrs. ROUKEMA. Will the gentleman yield?

This is a very interesting question that you have posed, and I would like to ask for a point of clarification or rather a point emphasis, and to correct me if I am wrong, with both Mr. Brendsel and Mr. Johnson.

Mr. Watt initially referred to your market as being higher risk markets. That may be somewhat of a misstatement. In the context in which I think of higher risks, I would suggest it is FHA that was established for the higher risk mortgage market. And we must be careful to understand that neither Freddie Mac nor Fannie Mae are surrogates of HUD.

What they do, as I think has been very adequately explained here today, they do provide access to the mortgage markets and the capital—the capital markets for the mortgage markets, and that is important.

And there is an element, although a strong element, of taxpayer risk here if the underwriting standards in these safety and soundness standards are not complied with. I think Mr. Watt and I are saying the same thing. But his question has led to a very informative discussion here to put you in the proper context of the law, and of the markets for which you serve.

Mr. JOHNSON. May I respond for just a second?

One of the reasons I made reference in both the testimony and in the oral comments that I started off with to FHA is exactly the reason you mentioned. As we are getting more and more aggressive about reaching out to cities, inner cities, to minority borrowers, and the FHA is getting focused on doing more and more of that themselves, it is critical over the long term that we have the right kind of partnership with the FHA, because they have a number of responsibilities, we have a number of responsibilities. We shouldn't be competing against each other. We should be partners of each other.

Our statutory background emphasizes low-, moderate-, and middle-income families. So we have a much broader service span than the FHA does. But as we get more aggressive about serving central cities and other areas that really need help, we will be in closer working quarters with the FHA. We already are in a number of circumstances. And one of the things we will have to do over time is get that straight.

Mr. WATT. Mr. Chairman, I realized I used my time on the philosophical here, but I have two very short questions that I think can be answered very quickly that are a lot more specific than that.

Mr. Johnson, you indicated that this refinance, the 60 percent of your mortgages are refinances this year, and that is skewing your other——

Mr. JOHNSON. Counting.

Mr. WATT. Counting. And you mentioned the 13-percent figure, which I was hoping would be higher, but I think part of the reason it is not higher, if I understand what you are saying, is that 60 percent of your work this year is refinancing.

If you factored out the refinancing, are you able to tell us what that percentage is?

Mr. JOHNSON. I am not, unfortunately, off the top of my head, but I would be happy to send you a note with that.

Mr. WATT. If you could just provide that information to us. I remember you said to Mr. Vento it was better, but you didn't say how much better.

[The information referred to can be found in the appendix.]

And finally, you talked some about the diversity of—I am sorry, I would like to have that from Freddie Mac also, if you could give us that information.

Mr. BRENDSEL. Absolutely. We would be happy to do that.

[The information referred to can be found in the appendix.]

Mr. WATT. And to both of you, Mr. Johnson in particular talked some about diversity of work force. Can you say a few comments,

each of you, about what kind of progress we are making, not only in terms of diversity of work force, but diversity at the management levels and higher management areas?

Mr. BRENDSEL. Let me make comments in two areas: One, with regard to work force, and second, with regard to other areas of our business, including the mortgage lending business.

With regard to diversity of work force, frankly I didn't bring statistics with me. Let me just emphasize first that it is very important, a very high priority for us to have diversity, not only in terms of——

Mr. WATT. Can you provide those statistics to us? I know Mr. Johnson's organization has been very aggressive on that front, and you may be also. I just don't know as much about——

Mr. BRENDSEL. We would be happy to provide the statistics to you. In fact, not too long ago we provided statistics to the committee in that regard.

[The information referred to can be found in the appendix.]

Certainly, in that regard we would undertake a number of outreach programs in terms of hiring as well as in terms of development and promotion of minorities, and frankly women as well, into the management ranks of the company.

With regard to mortgage lending, as I already indicated in my comments both in the written statement as well as in the oral discussion earlier, removing obstacles and barriers and reaching out to minorities in the mortgage lending process to ensure that we are working with lenders in every possible way so that they can make loans to minorities is of critical importance to us. In fact, as I indicated earlier, through a number of efforts with regard to studies and review of our guidelines in working with lenders, we are attempting to do everything we can in that area.

With regard to other areas of our business, whether it is securities issuance, or whether it is legal work, we take the general approach that we should have no restrictions in our business policies that inhibit doing business with minority firms or smaller firms that don't make sense from an absolute business basis; second, that we should reach out in terms of education and information to minority firms and smaller firms, so that they know how they can do business with us.

There are many examples that I could provide. One, if you take some time and travel out to Dulles Airport, you drive by our buildings along the way; along the Dulles toll road, we have two buildings under construction, one of those was designed by a small minority firm in the area.

Mr. JOHNSON. I will be very brief, Congressman.

In the last 2 years we made the diversity of our work force a core value at Fannie Mae, and we intend to be diverse up through all levels of management and are making very good progress in that regard. I will be happy to give you the specific numbers, but at all levels of the company, whether it be manager, director, vice president, senior vice president, all the way up to the vice chairman of our company, we have made progress that I in fact am very proud of.

Also, in the minority contracting area, we have been very slow to move as fast as we should, but if you look now at the numbers,

in 1992, only 1 percent of the outside contracting that Fannie Mae did was done with minority contractors. We have now, for 1993, we will hit a level of 16 percent, because we have now put in place a very effective program.

We have also in the last year put into place a very effective program of using minority and women-owned investment banking firms. Since we are the largest issuer of securities in the United States outside of the U.S. Government, we have an enormous use for people who are in the investment banking field, for the distribution of our securities.

We now have 10 minority and women-owned firms who have been added to our debenture selling group. We have minority- and women-owned firms now active in our REMIC Issuance Program, and we are making very substantial progress there.

We would be very pleased to give you figures in all these areas. I think we are moving along reasonably well.

[The information referred to can be found in the appendix.]

Mr. WATT. Thank you, Mr. Chairman. I appreciate the Chair's indulgence.

Chairman GONZALEZ. Well, thank you, Mr. Watt.

If I may be permitted to make an observation, when you initiated your discussion, you mentioned what appeared to you to be a dichotomy; that is, a conflict between the avowed intent of the two institutions. The word that disturbed me was the word you used, "risk." It has been our hope that they wouldn't even think of that word. And the Housing Act, section 304, mandates that the Fannie Mae be confined to mortgages which would meet minimum creditworthiness.

That is the word that I would prefer to the word "risk." Because when you talk about involving in risky ventures, that is the thing we have been most concerned with. I think what you really meant was, is there a conflict between the intention to meet the goal of confining the mortgage activities to those that meet minimum creditworthiness standards.

Of course, I am not in the business, you may have been, and how you interpret "minimum creditworthiness" I am sure is a first-class task in its own self. But I did want to make that observation.

Mr. WATT. Mr. Chairman, I appreciate that. Out in my community, when in here they are saying aye, we just say yes. So it is just one of those semantic things, I suppose.

Chairman GONZALEZ. Well, let us then end up as we started, by thanking both witnesses.

And, Mr. Brendsel, I am delighted to hear of your reentry into multi-housing. As you will recall in 1989, when you announced the departure, I was quite aroused about it. We had a meeting on that subject matter. So I am very happy to see that you are going back into it.

Mr. BRENDSEL. Thank you, Mr. Chairman.

Chairman GONZALEZ. The other thing is that what I have always said, and at the inception of this concept of secondary mortgage institutional activity was that at that time in the early 1970's you had a primary, although quite speculative and bubbly, nevertheless there it was.

Since then, my big fear is that the secondary is going up here and it has left little or no existing primary with the dissolution of the financial institutional framework of reference that was created actually before the war in the 1930's in order to provide that financial framework of reference to the national commitment to a family wishing and desiring to have a safe, affordable, and decent house.

Therefore, we had the disappearance of that great institution known as the long-term fixed mortgage and with the great aberrations of the markets and the consequent reflection in the soft underbelly known as the savings and loan. They were predicated on having interest stability inasmuch as they had that regulation Q advantage in order to enable them to provide for that real stable 30-year fixed mortgage, which enabled the average family at the time and since then and up to about the late 1970's. So I am disturbed by the fact that we have not fully restored it.

Just the other day we had a hearing on the National Home Ownership Trust, and the hearing was very, very significant, because of the witnesses. One of them was a homebuilder all the way from the far west coast, Oregon. The witness stressed the fact that they desperately needed and were very, very anxious to have what I have labeled the National Home Ownership Trust Fund.

I am the one that put that legislation through, and finally did in the 1990 Housing Act, but it hasn't been funded. One of the key intentions was to provide at least the start of finding an alternative to that framework of reference that has collapsed in the meanwhile.

So I am hoping that you all will join us in trying to push for its extension next year, and also the funding of that trust. I believe it is the only way we can eventually come around to it, and restoring, at least in the home ownership area, single-family home ownership area, some measure of restoring the national commitment and the production of housing and affordable rates, and in terms that particularly the young and the new first-time home buyer will be able to have their own home.

So I will leave with that thought in mind. It is a little selfish on my part, because I have been the author of that idea. And in fact thought of it since the middle 1970's when it was obvious that a crisis was coming around us, and the first harbinger of it was the REITs, or the Real Estate Investment Trust scandals, which were actually basically no different than what happened later in the 1980's, to our travail.

So we are thinking, how long is it going to take the Congress and the private sector to realize that this whole apparatus that was devised before the war is crumbling around our ears. We have to find ways to be as efficient in meeting that challenge as those forebears of us were in the 1930's.

So with that thought, I want to thank you. And unless you have some additional statement or questions you may wish to raise, we will consider the subcommittee and committee as adjourned until further call of the Chair.

[Whereupon, at 12:30 p.m., the hearing was adjourned, subject to the call of the Chair.]

APPENDIX

November 19, 1993

Opening Statement of
Chairman Henry B. Gonzalez
Hearing on Government Sponsored Enterprises
November 19, 1993

The Subcommittee on Housing and Community Development is holding this hearing in order to focus on issues related to two of the Government Sponsored Enterprises under the Subcommittee's jurisdiction - the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association.

The Subcommittee is particularly concerned about these GSEs compliance with the recently published interim affordable housing goals for both of these Corporations. The Subcommittee expects that both GSEs will be able to more than fully meet both the interim housing goals that were published on October 13, 1993, and the long-term housing goals set-forth in statute.

Congress established the affordable housing goals because of the previous lack of concrete information on both Freddie Mac and Fannie Mae's activity in the area of housing for low-income persons. While HUD has had regulations since the 1970s requiring that 30% of Fannie Mae's mortgage purchases be for low-and moderate-income persons. It, however, has not been clear that low-income persons have benefited in any way from the previous HUD requirements.

The Subcommittee, thus, created specific low-income housing goals

for these GSEs. These goals are contained in Title XIII of the Housing and Community Development Act of 1992, which is also referred to as the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. This statute establishes 3 primary low-income housing goals: 30% of the GSE's conventional mortgage purchases must be to finance housing for low and moderate income families; 30% of the GSE's conventional mortgage purchases must be to finance housing located in central cities; and the GSEs must purchase conventional mortgages for specific special affordable housing goals of $1.5 billion for Freddie Mac's purchases and $2 billion for Fannie Mae's purchases.

The Subcommittee is also very concerned about the capital adequacy of each of these GSEs, particularly since both these GSEs have a line of credit with the United States Treasury of up to $2.25 billion. The GSE Act establishes 3 new capital levels for these GSEs, which include the "risk-based" level, the minimum level, and the critical level. The Subcommittee created these capital standards to protect against any necessary draw from the federal government and to ensure that these institutions not take unnecessary risks without adequate safety and soundness criteria.

I now look forward to the testimony from these secondary mortgage market institutions.

11/19/93

REMARKS OF
HONORABLE MARGE ROUKEMA
GOVERNMENT SPONSORED
ENTERPRISES

Mr. Chairman, I want to welcome our distinguished witnesses today.

As an aside, Mr. Chairman, I want to take a moment to say to Mr. Johnson how much I appreciated the lenders conference FANNIE MAE sponsored in Saddlebrook, New Jersey last Friday.

Although I had intended to address the conference, a last minute scheduling conflict caused me to miss it. However, I do appreciate FANNIE MAE'S interest in working with the lenders in our area of the State to help promote homeownership opportunities.

FREDDIE MAC and FANNIE MAE were chartered by the Congress as stockholder-owned, privately managed corporations to provide an affordable and adequate supply of mortgage credit to those citizens seeking the American dream of homeownership.

We continue to support this objective.

Clearly, FREDDIE and FANNIE are doing what they were chartered to do. Recent highly impressive quarterly earnings reports by both organizations, especially in light of the general state of our real estate and home construction markets, and the troubles our banks and thrifts were having with their real estate portfolios, is a great credit to the leadership of Jim Johnson and Leland Brendsal.

AFFORDABLE HOUSING

In the GSE legislation we passed two years ago we mandated a new affordable housing requirement because it was felt that the benefits of the Federal charter enjoyed by the enterprises should place certain responsibilities on these entities.

One of these responsibilities is to use the resources and expertise of the enterprises to invest in and encourage investment in housing that benefits low- and moderate-income families.

This is not to say that the enterprises were not being responsive to the needs of the low-income community. In fact, both FANNIE and FREDDIE have over the years developed substantial and innovative investment programs for low-income families.

Nevertheless, the bill included a carefully crafted program to encourage the further investment in low-income housing.

Under this program, FANNIE and FREDDIE were required to establish affordable housing goals which would require the GSEs to make certain levels of mortgage purchases. The purchases would target both single and multi-family housing and those individuals and families with at certain income levels.

This compromise, which was worked out by the GSEs and the housing advocate groups, represented a positive step in the right direction for the provision of affordable housing for all.

On October 12, HUD officially announced the affordable housing goals for the GSEs. These require that 30% of GSE business be directed to finance low- and moderate-income housing and that approximately 30% of that goal should come from mortgage purchases in central cities.

These goals are appropriate for the GSEs

They are achieveable, although I understand that the central cities goal has raised some questions by the GSEs.

And they have the support and commitment of both FANNIE AND FREDDIE.

I want to make it perfectly clear, however, that these GSEs are not HUD and they never should be considered a substitute for HUD as the Agency in charge of setting out and fulfilling the housing policy of this nation.

Finally, while the affordable housing goals established for the GSEs is laudable, these goals must not ever place the safe and sound operation of the GSEs in any jeopardy.

The achievement of these goals will result in hundreds or even thousands of new homeowners who otherwise may never have had the opportunity to embrace the ultimate American dream.

I know both Mr. Johnson and Mr. Brendsel have committed themselves to meeting these goals and I appreciate their efforts.

CAROLYN B. MALONEY
14TH DISTRICT, NEW YORK

COMMITTEE ON BANKING, FINANCE
AND URBAN AFFAIRS

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OPENING STATEMENT
Subcommittee on Housing & Community Development

Hearing on "Issues Related to Government Sponsored Enterprises"
November 19, 1993

Thank you Mr. Chairman. I appreciate your scheduling this hearing on the important issue of GSE compliance with affordable housing goals. As I mentioned at previous hearings, I believe that the Federal Government, and all of its affiliated enterprises, has few more important responsibilities than creating and maintaining affordable housing.

In years past, this Subcommittee faced difficulty in obtaining concrete information about the efforts of Fannie Mae and Freddie Mac to help create affordable housing. Despite mandates from the 1970s that 30% of the mortgages purchased by Fannie Mae be for moderate and low-income persons, information on success of these goals was sketchy.

I do believe that GSE's, overall, have benefited the creation of new housing in the US. But I believe, that as a Federally-sponsored entity they must serve the greater goal of the creation of affordable housing. Without a decent place to live, all of the other individual rights we hold so dear, are impossible to achieve.

Again, my thanks to Chairman Gonzalez for scheduling this timely hearing.

Carolyn B Maloney

TESTIMONY OF LELAND BRENDSEL
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BEFORE THE SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
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I. Introduction

Good Morning Chairman Gonzalez, Congresswoman Roukema and Members of the Subcommittee, it is a pleasure to be here. My name is Leland Brendsel, and I am Chairman of the Board and Chief Executive Officer of the Federal Home Loan Mortgage Corporation, commonly known as Freddie Mac.

I want to thank you for the opportunity to appear before you to discuss the secondary mortgage market, the interim housing goals ("the housing goals") established by Congress in the Federal Housing Enterprise Financial Safety and Soundness Act of 1992, ("the GSE Act") and implemented by the Department of Housing and Urban Development ("HUD") by notice in the Federal Register on October 13, 1993, and Freddie Mac's commitment to meeting those goals.

Mr. Chairman, over the course of your distinguished career on the Banking Committee, you have been a leader in mortgage finance issues, and your support has benefitted the secondary market, Freddie Mac and America's homebuyers. The enactment of the GSE Act last year was another example of your support. As a result of your actions, the Congressional success stories known as Freddie Mac and Fannie Mae have a modern regulatory structure, including innovative capital standards. I would like to thank you for your efforts and support in that regard.

In addition to creating a new regulatory system, Congress in the GSE Act asked us to focus on extending the benefits of the secondary market. That request is embodied in the housing goals recently promulgated by HUD. My testimony will focus primarily on those goals and our strategy to achieve the housing goals; however, I would like to discuss briefly the secondary mortgage market and recent events before I proceed with a discussion of the housing goals.

II. Background

A. The Secondary Market and the Housing Finance System Today

America has the best housing finance system in the world, in large part due to the

existence of a strong secondary market. Today mortgage credit is widely available across the country on the best terms that the capital market has to offer. We estimate that the efficiencies produced by the secondary market currently save American homebuyers approximately 1/2 of one percent, or about $5 billion each year.

The secondary market serves as a link between the primary mortgage market, where mortgages are originated, and the national and international capital markets. In other words, by purchasing mortgages with funds obtained from the capital markets, Freddie Mac enables individual homebuyers to compete with General Motors and other large corporations for capital. Freddie Mac purchases conventional mortgages from primary lenders across the nation and packages the lion's share of those mortgages into securities. We, in turn, sell the securities to investors so that the cycle can begin again. This process allows a homebuyer in Texas the same access to mortgage funds as a homebuyer in California or New Jersey.

Congress created Freddie Mac and extended Fannie Mae's authority to purchase conventional loans with the Federal Home Loan Mortgage Corporation Act in 1970. At that time the housing finance market looked very different from today's market. Prior to 1970, the cost and availability of mortgage credit varied by region because the primary source of funds for mortgage credit -- thrift institution deposits -- may not always be plentiful in the areas needing such credit. In addition, the individual homebuyer had no access to the national and international capital markets. Variances in mortgage funding affected not only the individual homebuyer but also the housing market and economy as a whole. As you have often noted, Mr. Chairman, the housing industry provides jobs, so that there is a critical need for a steady and reliable source of funds.

Freddie Mac was created to address these regional credit variances by developing a national secondary market in conventional mortgages. To accomplish this mission, Freddie Mac and Fannie Mae built the infrastructure for this market through the development of standardized mortgage loan documents and underwriting guidelines that allowed for the wholesale purchase of loans on a nationwide basis. Freddie Mac also assembled a network of primary market lenders, commonly referred to as Seller/Servicers. Through this network, we have bought and will continue to buy loans in good times and in bad in all geographic regions of the country. We did that during the hard times in Texas in the 1980s and we are doing that now in the northeast and California. We view nationwide reliability and geographic diversity as important reasons why there has been no credit crunch in housing finance, despite the substantial contraction of the thrift industry.

Freddie Mac continues to be the leader in developing and refining the mortgage securitization process. In 1971 Freddie Mac developed the first conventional mortgage-related security, or Mortgage Participation Certificate, which we nicknamed

the "PC." In 1983, we designed the Collateralized Mortgage Obligation, or CMO, to bring what at the time were non-traditional investors, such as pension funds and insurance companies, to the mortgage marketplace. The CMO was the forerunner of the Real Estate Mortgage Investment Conduit ("REMIC") multiclass security which is an integral part of today's mortgage financing market. These innovations in the secondary mortgage market have attracted a large and global base of investors to mortgage-related securities. Without their confidence, we would not have this low-cost, reliable source of funds for housing.

The liquidity provided to primary market lenders by the secondary market fosters competition by those lenders, resulting in more mortgage products and enhanced affordability for the homebuyer. By having an outlet for their new products, mortgage lenders are able to offer consumers a range of mortgage products to meet their individual situations. In this way, the secondary market has led to innovation in the primary market. The ultimate beneficiary of this competition and innovation is the American homebuyer or renter whose rates or rents are lower, whose choices are expanded and whose sources of credit are more reliable.

B. Corporate Governance Changes at Freddie Mac

The past four years have been a time of tremendous change at Freddie Mac. In particular, the change from quasi-governmental ownership to wholly private ownership has been revolutionary.

The enactment of the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA) significantly changed Freddie Mac's corporate governance structure. Prior to 1989 Freddie Mac's stockholders were the saving and loans and other members of the Federal Home Loan Bank System. Under FIRREA our preferred stock was converted to common stock, and general public ownership of Freddie Mac was permitted for the first time. FIRREA also authorized a new Board of Directors for Freddie Mac, 13 of which are elected by the shareholders, and five appointed by the President of the United States. FIRREA completed the transformation of Freddie Mac from a quasi-governmental agency to a shareholder-owned private corporation. By providing stable corporate governance and access to equity capital, this change strengthened Freddie Mac's ability to meet the nation's housing finance needs.

C. The GSE Act

In 1989, when Congress passed legislation to address the thrift crisis, it also requested studies on the financial safety and soundness of Freddie Mac and Fannie Mae from the Congressional Budget Office ("CBO"), the Department of the Treasury ("Treasury"), the General Accounting Office ("GAO") and others. These studies found that neither Freddie Mac nor Fannie Mae presented an imminent financial risk to the government; but the studies did recommend that the regulatory system for Freddie

Mac and Fannie Mae be modernized. As a result, Congress, in the GSE Act, established the Office of Federal Housing Enterprise Oversight ("OFHEO") to oversee the financial safety and soundness of Freddie Mac and Fannie Mae.

Freddie Mac carefully manages its risks and has considerable real capital to support them, as confirmed by the CBO, GAO and Treasury. Nonetheless, Congress sought to safeguard the financial soundness of Freddie Mac and Fannie Mae by including innovative capital requirements in the GSE Act. The GSE Act provides for three capital standards--critical, minimum and risk-based. To meet the critical capital requirement, Freddie Mac must hold 1.25 percent capital for our on-balance sheet assets, and 0.25 percent capital for our off-balance sheet assets. To meet the minimum capital requirement, Freddie Mac must hold 2.50 percent capital for our on-balance sheet assets, and 0.45 percent capital for our off-balance sheet assets. As of the end of the third quarter of 1993, Freddie Mac's exceeded the applicable critical and minimum capital requirements.

The risk-based capital standard is the most dynamic of the three. It requires Freddie Mac to hold sufficient capital to withstand 10 years of adverse changes in interest rates and mortgage defaults, as defined in the GSE Act. This test is dynamic, changing the capital requirement as our exposure to interest-rate risk, resulting from rising or falling interest rates, and credit risk, resulting from higher default losses, changes. This test is similar to Freddie Mac's internal risk-based capital test, which we pioneered as a tool for prudent financial management. In addition to the capital required by this test, the enterprises will have to hold an additional 30 percent to cover management and operations risk. The dynamic nature of the GSE Act risk-based capital standards distinguishes it from other so-called "risk-based" capital standards, such as those applied to insured depository institutions. Those standards present a fixed capital ratio requirement for each asset held, based on the degree of risk associated with that general category of asset. The risk-based capital standard in the GSE bill is the most rigorous capital standard in the financial services industry, and Freddie Mac intends to meet this standard when it is implemented.

This new regulatory requirement includes the most forward-looking capital standard in existence. By automatically adjusting to economic conditions, this capital standard reduces the need for regulatory involvement in the operations of the GSEs. However, should either entity fall below the Congressionally established and regulatorily monitored capital standards capital standards, the regulator has appropriate tools and authority to ensure that the government's financial interest is adequately protected. We look forward to working with OFHEO Director Alvarez in implementing the legislation through regulation.

In addition to establishing the capital standards, the GSE Act also authorized the Secretary of HUD to establish housing goals for each enterprise.

III. The Housing Goals

Freddie Mac's corporate mission is, as a shareholder-owned corporation, to improve the quality of life by making the American dream of decent, accessible housing a reality. In describing our efforts toward meeting the housing goals, I want to stress that Freddie Mac has been in the business of affordable housing throughout our 23-year history. Since our creation, approximately one in four of the more than 12 million loans we have purchased has been for families with low or moderate incomes.

We are proud of all we have accomplished. Moreover, we are dedicated to extending the benefits of the secondary market as widely as possible. This is a challenge that we welcome.

The housing goals established by HUD are tough and challenging. However, Freddie Mac is committed to meeting them. There are three goals covering a two-year period: the low- and moderate-income goal, the central-cities goal and the special affordable goal. The housing goal for Freddie Mac's purchase of mortgages secured by housing for low- and moderate-income families ("low- and moderate-income housing goal") is 28 percent of the total number of dwelling units financed by the mortgage purchases of Freddie Mac for 1993 and 30 percent for 1994. The housing goal for Freddie Mac's purchase of mortgages secured by housing located in central cities ("central-cities housing goal") is 26 percent of the total number of dwelling units financed by the mortgage purchases of Freddie Mac for 1993 and 30 percent for 1994. The special affordable housing goal for the two-year transition period (1993-1994) for Freddie Mac equals two times the dollar volume of Freddie Mac's 1992 purchases that meet the income requirements of the special affordable housing goal plus $1.5 billion.

Freddie Mac has begun to amass extensive, automated data to learn about the housing market and to monitor our mortgage purchases and policies. Effective January 1, 1993, we required Seller/Servicers to provide data on borrower income, borrower race and information to enable us to determine census tract location, as required by the GSE Act. With this information we will be in a much better position to analyze our performance relative to the housing goals.

We are actively working to collect complete and accurate information. Because these data collections efforts are relatively new, at this time we can provide only approximate figures for our 1993 mortgage purchases. We estimate that from January to September 1993, about 27 to 29 percent of the housing units securing our mortgage purchases were for families with low and moderate incomes. The data recently released under the Home Mortgage Disclosure Act ("HMDA") show that approximately 26 percent of Freddie Mac purchases for 1992 served low- and

moderate-income households. However, the HMDA data do not include all of Freddie Mac's purchases that are applicable to meeting the housing goals. For the first nine months of 1993, we estimate that 21 to 26 percent of the housing units that secure our mortgage purchases financed properties located in central cities.

The multifamily market faces unmet credit needs, particularly in comparison to the single-family market. Freddie Mac's re-entry to the multifamily market by the end of 1993 will be crucial to our ability to meet the housing goals. A significant portion of the multifamily mortgages we purchase will be secured by buildings located in central cities. In fact, our re-entry to the multifamily market is the most important single step we will take toward achieving our corporate mission and meeting the housing goals.

Our ability to meet the housing goals depends on Freddie Mac having a sound strategy that we pursue aggressively. The ability to use that strategy to meet the goals, in turn, depends on the feasibility of those goals. One purpose of the transition period is to examine the market to determine what constitutes feasible goals.

We are concerned, however, about the 30 percent central-cities goal in 1994. These concerns are based on several factors. First, we question the assumptions made by HUD in establishing this goal, in particular, about the size of the central-cities conventional mortgage market. We raised this in our response dated August 11, 1993 to Secretary Cisneros commenting on the proposed goals. As a secondary-market enterprise we can only purchase what the primary market originates. The effect of overstating the size of the market is to create a central-cities housing goal that may be unrealistic and infeasible.

The second concern involves Freddie Mac's ability to identify single-family loans made in central cities. Prior to the enactment of the GSE Act, Freddie Mac was not able to identify the census tract for each single-family loan we purchased. However, to meet the requirements of the GSE Act we have developed that capability through our geocoding system, which we began using in August 1993. This system is refined and will be fully operational in January 1994. Our ability at this time to identify all of the loans that we have made in central-city census tracts is limited. Despite these concerns, we intend to make every effort to meet this housing goal, and we look forward to working with HUD in the future to improve the central-cities analysis.

We are looking forward to working with HUD and Congress during the 1993-1994 transition period. This period provides an opportunity for Freddie Mac and HUD to increase their understanding of underserved segments of the housing market, the financing needs of those underserved segments and the appropriate role of the conventional secondary market in addressing those needs. We expect that the information we are gathering on mortgage purchases during this transition period and the extensive research efforts we are undertaking will contribute to this understanding, and in so doing help HUD in the establishment of housing goals -- and

measuring performance against those housing goals -- beyond the transition period.

IV. Strategy to Meet Interim Goals

A. General Philosophy: Build on What Works

Freddie Mac's strategy is to expand underserved markets' access to mortgage credit by expanding our mainstream programs. In other words, we will meet the needs of these markets by capitalizing on the strengths of the secondary market: volume made possible by standardization, and sound underwriting principles. This means enhancing our standard single-family and multifamily programs. Taking advantage of the strengths of a successful system, is the best way to achieve the volume necessary to meet our corporate mission and the housing goals.

As part of our strategy, we use pilot programs and other targeted initiatives to increase our understanding of the needs of the underserved, to experiment with new mortgage products to meet those needs and to develop approaches to managing their unique risks. The ultimate purpose of these efforts is to identify successful products and approaches that can be incorporated into our existing purchase programs.

We are committed to building on the proven success of the secondary market, which has witnessed explosive growth during the past decade. In 1980, Freddie Mac purchased almost $4 billion in mortgage loans; in 1993 we anticipate purchasing more than $200 billion. Such volume would not be possible without a standardized process that allows qualified primary market lenders of different types to originate mortgage loans that they can be confident can be sold to secondary market institutions. The ultimate goal is to provide homebuyers, tenants, and affordable housing developers and lenders access to the existing highly successful secondary market system. Only by taking advantage of the efficiencies of this system, and providing profitable business opportunities for all, will financing for underserved markets benefit from the full scope and scale of the secondary market.

Our success in expanding the breadth of our activities will also depend on our adherence to sound underwriting practices. Underwriting is used to assess the ability of a borrower to take on a financial obligation. Defaults are bad for investors, bad for borrowers and particularly bad for neighbors. Our challenge is to understand the risk involved in addressing the needs of the underserved, and to find ways to mitigate and control that risk. In that way we can ensure the investment quality of the loans we purchase and the credit quality of the securities we issue.

Focusing on our mainstream operations to achieve our mission and the housing goals reflects our strong belief that affordable lending can be, should be and is part of our

standard business base.

B. The Current Housing Environment

This country has made a great deal of progress since President Roosevelt spoke of one-third of a nation ill housed. In the Housing Act of 1949, this country established the policy of a decent home and suitable living environment for every American family.

Between 1940 and 1991, the fraction of households in units with incomplete plumbing facilities fell from 40 to 2 percent; the fraction who were overcrowded (that is, more than one person per room) fell from 20 to 5 percent; and the fraction who own their homes rose from 42 to 64 percent.

There continue to be a sizeable number of households with unmet housing needs. After years of steady improvement, the homeownership rate began to decline in 1980, falling from a high of 65.6 percent to 64.1 percent in 1992. Many of these needs reflect adverse trends in both the level and the distribution of household income that began in the early 1970s. Real incomes grew by over 30 percent per decade in the 1950s and 1960s. Since that time there has been a steady erosion in the earning capacity of Americans with only a high school education, and median household incomes have remained relatively flat -- growing by only 6 percent in the past decade.

Households at the bottom of the income distribution -- many of whom are female-headed households with children -- have fared even worse. These households have experienced an absolute decline in real income over the past two decades due in part to the growing numbers of single-parent households and in part to the secular decline in this country's manufacturing base.

The concentration of the poor -- particularly members of minority groups -- has made their housing problems more acute. Many low-income communities today have virtually lost their economic base and no longer provide the basic security all Americans should expect. Moreover, minorities also face discrimination in both the housing and mortgage markets. Such discrimination has helped to maintain a highly segregated housing market, and led to a higher incidence of substandard housing and depressed homeownership rates among African-American and Hispanic households.

Conditions in the housing market reflect the social and economic environment.

Many of their effects cannot be addressed by Freddie Mac directly, but we can address their consequences through creative actions. In both the single-family and the multifamily areas we have tried to address specific housing needs, such as the needs of central-cities residents, focusing our activities on a number of key areas, such as reducing unnecessary underwriting barriers, where our potential to add value is relatively high.

I would now like to discuss briefly Freddie Mac's actions to meet housing needs. The report on our housing strategy that we will deliver to HUD and the Congress next week pursuant to the requirements of §1337 of the GSE Act will provide a more detailed discussion of our actions.

V. Single-Family Financing

America's housing finance system has been successful in providing housing for most American families. With falling interest rates, the system has supported both the huge demand for refinancing and the resurgence in demand by first time homebuyers.

The secondary mortgage market has played an enormous role in this success, especially in the single-family market. The secondary mortgage market now finances over 40 percent of outstanding conventional residential mortgage debt. This year, two-thirds of the mortgages falling within the Freddie Mac/Fannie Mae loan limit os $203,150 will be sold into the secondary market.

Freddie Mac purchases single-family mortgages from our network of more than 2,300 Seller/Servicers across the country. In addition to purchasing mortgages originated by these Seller/Servicers, Freddie Mac also purchases mortgages originated by third-party originators ("TPOs"), for example, mortgage brokers. We estimate that 10,000 TPOs sell mortgages to Freddie Mac through our Seller/Servicers, dramatically expanding homebuyers' access to the benefits of the secondary market.

Freddie Mac purchases a wide variety of mortgage products through our standard programs, whether by paying cash or by swapping them for Freddie Mac PCs. In this case the phrase "standard programs" masks the flexibility of this process -- 90 percent of these sales are negotiated transactions, that is, they have special features to tailor Freddie Mac's guidelines and programs to the capabilities of individual underwriters and the needs of their customers. The types of mortgages Freddie Mac purchases include fixed-rate mortgages with 15- and 30-year maturities, adjustable-rate mortgages ("ARMs") of varying types and balloon/reset mortgages.

Freddie Mac will continue to purchase the vast majority of our affordable housing mortgages through our standard programs. In other words, achieving the affordable housing goals will require the extension of our current business, not the creation of a new one.

A. Expanding Standard Programs and Improving the Mortgage Delivery System

In order to expand our existing programs to bring the benefits of the secondary market to more homebuyers -- and to meet the housing goals -- we are:

- Reviewing and improving underwriting guidelines.
- Expanding the Seller/Servicer network.
- Using pilot programs to experiment with new programs and incorporating successful features into our standard programs.

Reviewing and Improving Underwriting Guidelines: Removing barriers to accessing the secondary market, wherever in the process, from origination to securities sale, is a critical factor in reaching underserved markets and an area in which Freddie Mac has been in the forefront of industry efforts.

In addition, underwriting guidelines continually evolve as the social and economic situation changes and information increases. To make sure that Freddie Mac's underwriting guidelines are being properly interpreted, we continually review how lenders use them. Following is a brief description of our efforts to review our underwriting guidelines and adapt them to new situations and information.

ICF Study: In 1990 Freddie Mac commissioned a groundbreaking study by ICF Incorporated. This study was designed to identify lenders' perceptions about secondary market underwriting guidelines and the extent to which these perceptions and specific aspects of the guidelines may be inadvertent and unnecessary barriers to community lending -- particularly lending to low- and moderate-income borrowers and minority borrowers. Through a series of focus groups conducted in 12 cities with representatives of 133 lending institutions, the study revealed that many lenders were unaware of the flexibility of our existing guidelines. Following the ICF Study, Freddie Mac convened an industry working group of community lenders and housing advocates to assist Freddie Mac in addressing the issues identified.

Bulletin 92-2: As a result of these efforts, Freddie Mac clarified or changed 28 sections of our underwriting guidelines, in a document formally released to Seller/Servicers as Bulletin 92-2. For example, Bulletin 92-2 expanded the list of acceptable sources of funds for down payments to include grants, which many municipalities and nonprofit community groups provide to low- and moderate-income borrowers. Bulletin 92-2 also added a provision in our underwriting guidelines reminding lenders that residential properties in mixed-use neighborhoods are indeed eligible for purchase.

UNBOG: The success of these efforts to identify and dismantle barriers led Freddie Mac to create, in early 1993, the Underwriting Barriers Outreach Group ("UNBOG") to continue the study of our mortgage underwriting process, identify potential barriers and make changes as necessary. UNBOG consists of four regional groups comprising representatives of community activists, development groups, the real estate profession, the appraisal industry, minority and non-minority lending institutions and

mortgage brokers, and Freddie Mac. The groups meet semiannually to study and recommend changes in the mortgage credit underwriting process that can reduce unnecessary barriers. Freddie Mac continually requests and addresses feedback provided by UNBOG participants.

For example, Freddie Mac has learned through UNBOG that lenders subject urban neighborhoods to more rigorous property standards than they do suburban neighborhoods, perhaps because of the greater age or architectural diversity of the housing stock typically found in urban centers. Freddie Mac's guidelines do not differentiate the treatment of older homes or homes with differing architectural styles, nor do they rely on remaining economic life. Changes to the Uniform Residential Appraisal report used by Freddie Mac that replace summary ratings of good, average, fair or poor with a requirement for the appraiser to explain neighborhood conditions and factors affecting marketability should help dispel any misconceptions lenders have, but we are also using UNBOG to find ways to further communicate our guidelines for properties in urban neighborhoods.

UNBOG has resulted in a number of recommendations that have inspired pilot programs, which I will describe later in this testimony. Freddie Mac's pilot programs will also be described in more detail in our report on the housing goals ("the report"), to be filed next week.

Expanding the Seller/Servicer Network: The existing mortgage delivery system has proven to be extremely effective. Nonetheless, Freddie Mac is committed to improving the delivery of mortgage credit to potential borrowers who are unable, through lack of knowledge, understanding or exposure, to make the mortgage system work for them. We have a number of initiatives underway to resolve non-credit related problems that may be preventing households from achieving homeownership.

Because Freddie Mac purchases loans originated by Seller/Servicers, any outreach program we conduct relies heavily on their ability to solicit, underwrite and originate housing loans. We are targeting marketing efforts toward those Seller/Servicers that are outperforming their peers in terms of the quality, volume and innovation of affordable lending in order to encourage and learn from their efforts. By doing so we hope to increase the volume of lending they are able to do and to communicate their successful strategies to other lenders.

We are spearheading efforts to reach lenders with whom we have not traditionally done business, for example, community development corporations, that could qualify as Freddie Mac Seller/Servicers. We have in fact recently added to our list of Seller/Servicers South Shore Bank, a community development bank located in Chicago. Moreover, we are also exploring ways to pair lenders that do not qualify as Seller/Servicers with our existing Seller/Servicers.

By expanding our network of partners in the origination process, Freddie Mac hopes to reach new borrowers. We hope to leverage the unique capacity and experience of institutions such as community-based lenders to assist underserved borrowers in overcoming unnecessary barriers to homeownership.

B. Pilot Programs

In addition to these activities designed to expand our mainstream business, Freddie Mac is conducting pilot programs designed to increase our knowledge of underserved markets and enhance lending to very low-, low- and moderate-income, central-city, and rural households through our standard programs. Freddie Mac has a number of pilots underway in this area, but for purposes of this testimony, we will focus on two that address borrower counseling: down payment requirements and underwriting guideline flexibility.

Borrower Counseling and Down Payment Requirements: Experience has shown that the equity borrowers have in their homes is the most important determinant of borrower defaults. For example, in Freddie Mac's experience, loans with only a 5 percent down payment default at a rate eight times that of loans with a 20 percent down payment. FHA experience shows that defaults increase even more rapidly when down payments fall below 5 percent.

Often potential borrowers can afford monthly mortgage payments but do not have the funds to meet down-payment requirements. The key to addressing this problem -- while continuing to minimize default risk -- is an accurate assessment of the potential borrowers' ability and willingness to continue to make mortgage payments.

Affordable Gold is our primary pilot program for testing flexible underwriting standards and how they can be balanced by other enhancements such as counseling. In the Affordable Gold pilot program, Freddie Mac lowers the up-front cash needed from borrowers by allowing up to 2 percent of the down payment to come from a gift, grant or unsecured secondary financing. Closing costs of up to 2 percent may also come from these alternatives. As a result, the Affordable Gold pilot also experiments with allowing lower down-payment requirements and broadening the sources of income that can be used to meet payment-to-income requirements. We have also increased underwriters' flexibility in determining whether the borrower's monthly income is sufficient to make the mortgage payments.

A critical component of Affordable Gold is the requirement that borrowers receive education or counseling, covering topics such as home selection, budgeting, loan application and closing procedures. Through Affordable Gold we hope to learn the appropriate balance between traditional methods of credit-risk control, such as expense-to-income ratios and down payment requirements, and alternative controls, such as counseling and underwriting by lenders experienced in low- and moderate-

income lending.

Maximizing Flexibility in Underwriting: Standard underwriting guidelines employ tools such as the ratios of housing costs to borrower income and total debt to borrower income to help the lender make underwriting decisions because standard guidelines are designed to indicate the amount of mortgage debt that borrowers can safely assume. Some borrowers, however, may be able to take on more debt without a significant increase in risk, so lenders have flexibility to exceed the guidelines if justified by other positive credit considerations.

One recently announced pilot gives lenders greater guidance in making those judgments. Freddie Mac's Alternative Qualification pilot with Sears Mortgage Corporation (a mortgage originator) and Mortgage Guaranty Insurance Corporation ("MGIC") (a private mortgage insurer) will develop and test a method for qualifying low- and moderate-income loan applicants based upon their demonstrated ability to make sustained debt payments. This pilot was initiated in Chicago and will be expanded to additional areas.

The intent of this pilot is to create a useful, practical tool for lenders to use in making judgments about an applicant's ability to pay allowing more low- and moderate-income borrowers to become homeowners, without increasing default risk. Freddie Mac will monitor the performance of mortgages underwritten under this alternative process and compare performance to loans originated under more traditional underwriting methods. The program will be reviewed to determine whether such methodology should be incorporated into our underwriting process.

C. Other Initiatives

In our efforts to expand our standard programs, Freddie Mac is conducting other special initiatives. Some combine our marketing strength with existing public-sector programs. Others focus on intensive research. For example, we have and are augmenting an extensive database with which to study underwriting guidelines and their relationship to the likelihood and cost of mortgage default. Our research agenda also includes the impact of economic and demographic trends on homeownership rates and mortgage demand, particularly for very-low-, low- and moderate-income and minority households. In addition, we have initiatives covering areas such as: improving the effectiveness of government subsidies; and the underwriting requirements for two-to-four-unit housing. Our interim report will discuss these in more detail.

V. Multifamily Financing

The economic and demographic pressures on the housing system in general have been

strongly felt in the multifamily market. The deteriorating income profile of renters and the rising costs of maintaining properties in inner cities, has produced a large and growing gap between the cost of operating a rental unit and households' ability to pay. While government subsidies are available to fill this gap, only a fraction of the eligible population currently receives government assistance. As a result, five million very-low-income households not receiving housing assistance have a "severe" housing problem as defined by HUD, that is they either they pay over half of their incomes on rent or live in a physically substandard unit. There is an urgent need, therefore, for sound, well-maintained buildings that provide decent, safe, rental housing.

These market conditions challenge Freddie Mac to implement multifamily programs with all due deliberation so that the programs will be both effective and sustainable. Freddie Mac is strongly committed to addressing the need for decent, safe and affordable rental housing through its various multifamily purchase programs and targeted initiatives.

A. Lessons Learned

Freddie Mac suspended its multifamily mortgage purchase program in late fall 1990, when serious delinquencies escalated, resulting in cumulative losses of more than $500 million. At that time, multifamily mortgage loans represented only 3 percent of Freddie Mac's portfolio, but generated almost one half of our total losses -- a loss rate 17 times greater than for single-family mortgage loans. Moreover, multifamily delinquencies and foreclosures had almost doubled in five years.

Many factors contributed to these losses. Some, like the 1986 tax law, declining property values and rents, and over-building, were economic or industry conditions over which we had no direct control. Other factors were, however, related to our multifamily program. Two key lessons from Freddie Mac's experience are:

- That sound multifamily financing requires well-designed programs, sufficient staffing and quality local lenders that know their neighborhoods as business partners.

- That when a multifamily loan defaults, it is the tenants and the communities that suffer.

The knowledge that we have gained as a result of a thorough analysis of our past multifamily experience has enabled us to design new multifamily programs that will aid us in fulfilling our mission and meeting the housing goals.

B. Re-entry into Multifamily Market

When the decision was made to suspend our multifamily operations, we clearly stated

the conditions necessary for our re-entry into the market. They were: (1) to stabilize our multifamily portfolio; (2) to develop programs, policies and procedures that reflect the unique nature of multifamily lending; and (3) to hire staff with the expertise necessary to make our programs successful. Freddie Mac has accomplished these objectives.

Our new multifamily programs will:

1. Purchase mortgages for the purpose of acquisition, rehabilitation, and refinance of existing properties.

2. Use state-of-the-art tools to underwrite, monitor and manage our multifamily purchases.

3. Select lenders for their capital and their multifamily experience in local markets.

Freddie Mac's redesigned multifamily programs will enable it to respond aggressively to the challenge of financing decent and affordable housing for America's renters. Meeting this challenge will enable us to fulfill our corporate mission and to meet the housing goals set by HUD.

We expect to purchase $100 million in multifamily loans this year as we complete our reentry into the market in December. Depending on economic and multifamily market conditions, we expect the level of our participation in this market to be significantly greater in the future.

C. Multifamily Strategy

Multifamily loans cannot be underwritten like single family loans. These loans must be individually underwritten and are more similar to a business loan than to a single-family mortgage loan. While two-thirds of new conventional single-family mortgages originated are financed through the secondary market, only a small percentage of the multifamily market is financed by this market. Because the secondary market for multifamily loans is in an earlier developmental stage in comparison to the single-family market access to capital markets through securitization is less readily available for multifamily loans. Furthermore, the distinct characteristics of multifamily loans create at present obstacles to standardization.

As with our single family strategy, many of our mortgage purchases under standard multifamily programs will qualify toward the housing goals. We will also develop pilot programs, especially to for very-low-income renters targeted under the special affordable goal. We will incorporate successful features of pilot programs into our standard programs wherever feasible, but we recognize that a more tailored approach

will be needed for multifamily market.

I would now like to describe briefly the components of our new cash multifamily purchase, the structured transaction program and our refinancing programs. Then I will describe one of our more important pilots win conjunction with the AFL-CIO; a program which you, Mr. Chairman, were instrumental in helping to develop earlier this year through the enactment of H.R. 2668.

Cash Program: Through this program Freddie Mac will purchase newly originated multifamily mortgages from Program Plus Seller/Servicers in exchange for cash. Freddie Mac is currently conducting a limited cash program, and we plan to fully re-open our multifamily cash purchase window by the end of December 1993. This program will include purchases of small ($350,000 to $1 million) loans.

Structured Transactions Program: Through this structured transactions program, Freddie Mac purchases multifamily mortgages from approved lenders in exchange for Freddie Mac multifamily PCs. This program was introduced in October 1993. By including both new and seasoned mortgages, this program facilitates the purchase of portfolios existing pools of mortgages from approved institutions. This program provides a source of liquidity so that lenders who have specialized in multifamily lending and have held the loans in their portfolios can continue and expand their activities.

Refinance Programs: Refinancing existing multifamily mortgages allows borrowers to reduce their debt burdens alleviating upward pressure on rents or permitting more of the cash flow to be used to maintain the properties. Cash from the refinancing above what is needed to pay off the original loan is available for property improvements and repairs or to establish replacement and repair escrow accounts.

Freddie Mac's Defensive Refinance Program, begun in July 1992, is designed to provide low-cost refinancing for mortgages held in our portfolio that are in danger of defaulting. The program allows lenders to provide new mortgage financing for up to 105 percent of the outstanding principal balance of the existing loan. Any excess cash from the refinancing must be reinvested in the property, for example to pay closing costs or to establish replacement and repair escrow accounts.

Freddie Mac's Quality Refinance Program, begun in February 1993, provides refinance mortgages for high-quality mortgages in our portfolio. This program allows lenders to provide new mortgage financing up to 125 percent of the outstanding mortgage principal balance of the existing loan. As in the Defensive Refinance Program, excess cash from the refinancing must be reinvested in the property.

In 1993, Freddie Mac purchased over $110 million of multifamily mortgages through the refinance program. More than 50 percent of these mortgages were in central

cities, and more than 95 percent were affordable to low- and moderate-income renters.

D. Pilot Programs

As with our single-family programs, multifamily pilots will be used to experiment and learn about underserved markets, with the aim of developing financing innovations that can be used on a broader scale in the future. Currently Freddie Mac has a number of multifamily pilot programs, designed to address the following: new partnerships, forward commitments, rehabilitation lending, disposition of real estate owned ("REO") and leveraging public subsidies. Freddie Mac will also use pilot programs to expand non-traditional Seller/Servicers' access to the secondary market. By initiating pilots with a range of non-traditional Seller/Servicers, such as housing finance agencies and community development and nonprofit organizations, we hope to expand the delivery system through which these lenders can access the secondary market. As we work to purchase mortgages that will meet the special affordable housing goal, we will seek to expand the availability of secondary market funds to these lenders.

AFL-CIO Pilot: Illustrative of Freddie Mac's strategy in using pilot programs to develop innovative financing techniques and to develop new partnerships is the pilot program between Freddie Mac and the AFL-CIO Housing Investment Trust announced on September 6, 1993. This pilot will fund up to $200 million in rehabilitation and new construction mortgages in 30 cities nationwide over the next 36 months, including properties with rents affordable to households earning at or below 60 percent of the area median income.

Before construction or rehabilitation begins, Freddie Mac provides a forward commitment to purchase the permanent mortgages once the rehabilitation or construction is completed. Freddie Mac buys the permanent mortgages in a swap transaction, that is in exchange for the permanent mortgages, Freddie Mac provides Freddie Mac PCs to the AFL-CIO Trust. These PCs are expected to be held by the AFL-CIO Trust as investments but they are more liquid than the underlying whole mortgages, are easily liquified should the Trust's investment needs change.

The pilot creates a partnership between state and local housing finance agencies and Freddie Mac that shares the credit risk of these mortgages in a way that takes advantage of each participant's relative strengths.

E. Freddie Mac/HUD Risk-Sharing

On October 28, 1993, Freddie Mac submitted a report to HUD and Congress to report our findings on an assessment of alternative methods of risk sharing. As part of this assessment, Freddie Mac began discussions with HUD to design and implement a joint

risk-sharing program for multifamily housing. These discussions are continuing so that the details of this pilot program have not been finalized. This pilot is intended to provide rehabilitation financing, including financing for properties in enterprise communities and empowerment zones. Risk-sharing is an opportunity for HUD and Freddie Mac to bring their respective strengths together to expand the supply of affordable rental housing and to revitalize communities.

For example, Freddie Mac has the capability of providing: expertise that results in the proper program design, a sufficient number of experienced staff, and appropriate management and reporting controls, all of which are needed for a successful program. Freddie Mac and its Seller/Servicers bring the expertise needed to underwrite individual multifamily properties and to manage the assets over time. Sound underwriting and asset management will produce high-quality loans and manage the government's and Freddie Mac's risk exposure.

HUD has the unique ability to provide and coordinate the delivery of federal subsidies. In addition, because the federal government is better diversified than any private-sector entity, it is better able to provide insurance against very unlikely but very costly risks that are difficult to anticipate. Local governments could also be risk-sharing partners in this pilot program.

Loans purchased under this pilot would provide attractive pricing to the borrowers and reasonable profit to Freddie Mac. These loans would help meet the housing goals, particularly the special affordable housing goal.

VI. Conclusion

Mr. Chairman, I want to thank you again for the opportunity to testify on behalf of Freddie Mac on the success of the secondary mortgage market and our commitment to build on it and to meet the housing goals. We look forward to succeeding in our efforts to expand access to housing through the secondary market.

(Mr. Brendsel)

RESPONSE TO QUESTION FROM CONGRESSMAN MEL WATT
RE REFINANCING
NOVEMBER 19, 1993 GSE HEARING

Freddie Mac has examined Home Mortgate Disclosure Act data for 1992, as well as our own data for 1993 (through September 1993) and have found no statistically significant difference between the minority share of home purchases versus refinance loans.

(Mr. Brendsel)

RESPONSE TO QUESTION FROM CONGRESSMAN MEL WATT RE
DIVERSITY OF WORK FORCE
NOVEMBER 19, 1993 GSE HEARING

Freddie Mac is committed to bringing diversity to its workforce, and in fact the mission statement of our employment office is ultimately to achieve a balanced, diverse work force at all levels, and to have Freddie Mac known as an organization where diversity is valued. To this end, we have established several programs and activities that are designed to expand Freddie Mac's diverse population of employees.

Since December 31, 1989, while the overall work force of the corporation grew 50 percent, the number of minorities grew by 63 percent -- an increase of 253 employees. Furthermore, the growth of the minority workforce for management level and above has increased by 74 percent during this same time period.

Among Freddie Mac Officers, almost 7 percent are minorities, which is up from 2 percent from early 1992. Additionally, 21 percent of our officers are women. In our management group below officer level, 50 percent are women and 11 percent are minorities.

Freddie Mac is pleased with the results of our efforts to promote greater work force diversity and we want to do more. In that regard, I will mention some of our policies and programs that serve to increase our diversity.

Freddie Mac's goal is to have at least one woman, minority or handicapped job applicant presented for 80 percent of all job requisitions. For 1993, we have exceeded this goal.

Additionally, our out-reach efforts include minority job fairs sponsored by a variety of minority institutions including the Black Human Resources Network. Freddie Mac also uses a number of search and recruitment firms when recruiting new employees. Many of the firms have been retained specifically because they have a reputation for finding diverse candidates. In all cases, however, Freddie Mac requires that minorities and women be presented on the candidate slate submitted by the recruiting firm. These efforts help us assure greater access to potential candidates, particularly at the top management levels.

To increase our outreach and achieve diversification at all levels of the corporation, we also have several programs targeted for entry-level jobs. For example, we are committed to take five students from INROADS, which places minorities, who are going to college, in companies for four consecutive summers. Additionally, Freddie Mac concentrates on universities with large minority populations for its own campus recruiting for jobs related to computer sciences and information services. Finally, Freddie Mac has an active internship program that requires that at least 50 percent of the interns to be minorities or women.

Statement for

James A. Johnson

Chairman and Chief Executive Officer

Fannie Mae

November 19, 1993

Mr. Chairman and Members of the Committee.

Thank you for holding this hearing and for giving me this opportunity to appear before you. We at Fannie Mae deeply appreciate the Committee's thoughtful leadership on housing and housing finance in America, and your lifelong dedication, Mr. Chairman, to providing decent, safe and affordable housing for every American family.

Mr. Chairman, when Leland Brendsel and I appeared before this Committee on May 7, 1992, you set before us some very important challenges. As you have noted many times, while the housing finance system in this country works very well for the vast majority of Americans, significant barriers remain for many people.

> Discrimination denies mortgage credit to minorities who are willing and able to buy a home.
>
> Consumers lack the information they need to deal with the complexities of the mortgage finance system.
>
> And high closing costs and down payment requirements make it impossible for many people who have steady incomes and good credit histories to obtain mortgage credit.

You challenged us to provide leadership to help break down these barriers. We eagerly accept and embrace the challenge. Fannie Mae is dedicated to making the housing finance system work for all Americans, regardless of race or economic circumstance, and we are taking action to achieve that goal. We have committed ourselves to eliminate every inefficiency, fight every trace of discrimination, build every possible economic bridge, and break down all artificial barriers in the housing finance system that stand in the way of affordable homeownership for families of modest means.

1993 has been a record breaking year for housing and for Fannie Mae. Our company's total business volume for 1993 will be over $300 billion, which will help finance homes for more than 3 million families. This exceeds last year's all-time volume record of $257 billion and 2.9 million families served. In just the past two years, Fannie Mae alone has done as much business as our nation's <u>entire</u> housing finance system handled in the first four years of the 1980s.

Refinancing, due to lower interest rates, is responsible for over 60 percent of our 1993 business. The ability of homeowners to refinance their mortgages has had a very positive impact on our economy. In fact, since 1991, homeowners have saved $30 billion in mortgage payments due to refinancing and the downward adjustment of adjustable-rate mortgages.

I am pleased to announce today that through a change in Fannie Mae policy we will extend the benefits of refinancing to thousands of additional families. Because of a decline in housing prices in a few parts of the country, some families have been unable to take advantage of lower interest rates through refinancing, because the equity in their homes has declined. To help these people lower their mortgage payments, Fannie Mae will allow the homeowners whose loans we hold to refinance with loan to value ratios of up to 95 percent. We believe this will be an enormous benefit to consumers, especially those living in areas where home prices have declined.

As you know, our strong commitment to affordable housing took on an added dimension when Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act last year. The new law reaffirmed Fannie Mae's role in our nation's housing finance system, and underscored the important role that Fannie Mae has in meeting the national goal of expanding decent, safe and affordable housing and homeownership opportunities.

We are moving ahead effectively to meet these goals because we have built a solid foundation in our affordable housing effort. In March 1991 -- within six weeks of assuming the chairmanship of Fannie Mae -- I challenged my fellow employees to provide $10 billion of financing during the following four years for low- and moderate-income families and others with special needs. This past August we achieved that goal -- 16 months ahead of schedule. As a result, 180,000 families are in homes of their own or in decent rental housing they could not otherwise afford. Through this $10 billion "Opening Doors to Affordable Housing" initiative, the establishment of our National Housing Impact Division, the 1,300 partnerships we've formed with lenders, state and local governments, nonprofit groups and others, and all the things we've done to build on those efforts, we have taken our impact on affordable housing to an entirely new level.

Specifically:

0 We made our Community Home Buyers program the industry standard in providing low down payment mortgages on flexible terms to lower income families and to those living in areas that have not had full access to credit.

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0 We developed FannieMaps -- a demographic data and mapping service to help lenders identify underserved areas with concentrations of low- and moderate-income and minority families.

0 We formed an effective financing partnership with the Farmers Home Administration under its Section 502 Rural Housing Loan program to provide no down payment loans in rural areas.

0 We created a secondary market for Home Equity Conversion Mortgages, which allow senior citizens to tap the equity in their homes through FHA insurance programs.

0 We developed a flexible line of products to provide lending for home renovation, including HomeStyle and the Community Home Improvement Mortgage Loan.

0 We began financing group homes that house the developmentally disabled. We've made other investments to help house those who suffer from AIDS or mental illness.

0 We launched our Employer Assisted Housing program, called Magnet, which helps employers recruit and retain workers in communities with high housing costs or tight labor markets.

0 We expanded our multifamily financing effort, which will fund about $5 billion in multifamily loans this year.

0 We have increased our investments in low-income housing tax credits, to $350 million in over 130 projects.

0 We created a Housing Impact Fund to make short-term loans to ventures that have significant impact on affordable housing, but fall outside our standard lines of business.

0 We launched a new FannieNeighbors program, through which we've made all residents of central cities -- as well as those living in lower income and minority neighborhoods -- eligible for our flexible Community Home Buyers program.

0 We've created a consumer outreach program that will provide millions of families information this year about affordable loans, and lists of lenders and counselors in their areas that can help them qualify. By year-end we will have helped more than 100,000 people who have called our toll free telephone number in response to this outreach program.

0 We've held home buyer fairs in four cities at which nearly 20,000 people were able to visit with lenders, counseling agencies, and attend panels to learn more about the home buying process.

0 We've begun a program of central city partnerships with the cities of Oakland and Cleveland, and will have a total of six additional partnerships in place by year-end. These partnerships use our existing affordable housing products -- and create new ones -- to address housing priorities that the cities set themselves.

0 We've purchased additional portfolios of existing affordable housing loans, making it easier for lenders to originate new ones.

- 0 We've created an MRB Express product to reduce costs for housing finance agencies in raising funds through mortgage revenue bonds to finance home loans at below-market interest rates.

And finally, as part of the process of extending mortgage credit to all eligible borrowers, we committed ourselves to fight every day to help eliminate all vestiges of discrimination that could deny homeownership to someone on the basis of race or ethnic background.

- 0 We've made significant changes to our underwriting guidelines to underscore our commitment to fight discrimination.

- 0 We've made it clear that we will not tolerate redlining on the part of any lender -- and we will not permit our guidelines to be the excuse for it.

- 0 We published a new guide for lenders on Underwriting Low- and Moderate-Income Borrowers, to assure that lenders are aware of all the flexibilities we have built into our underwriting guidelines.

0 We held 15 seminars around the country to give lenders hands-on experience in applying these flexible guidelines to make sure they know we want them to be used.

0 We've instituted a second management level review as part of our process for reviewing a sample of the loans we purchase to assure that they are conforming to our guidelines.

0 We've permitted our lowest down payment loans to be made in markets with declining property values, where a lender is participating in a public-private reinvestment effort.

0 We've dedicated ourselves to increasing the diversity of our own workforce, in order to serve minority borrowers more effectively and ensure that all levels of Fannie Mae management are dedicated and responsive to increasing opportunities for minorities in all aspects of our business.

These initiatives have positioned us well to achieve all our affordable housing goals. As this Committee knows, the 1992 Act established a new framework for reviewing our affordable housing activities, beginning with a two-year transitional period. HUD published implementing regulations on October 13 to guide our activities for 1993 and 1994. These regulations assign us three goals for this year and next. First, 30 percent of our business in each year is to provide housing for low- and moderate-income families. Second, during this two year transition period, we have a special affordable housing goal -- for low-income families in low-income areas and for very low-income families -- of $2 billion of mortgage purchases above a 1992 baseline. Half of these purchases are supposed to be mortgages on single-family houses and half are to support multifamily housing. Third, our goals for central city purchases are 28 percent for 1993 and 30 percent for 1994.

After this interim period, the statute envisages a number of changes. For example, the special affordable housing goal will be changed to not less than 1 percent of the dollar amount of purchases in the previous year. The current central cities goal is supposed to be expanded to address "housing located in central cities, rural areas, and other underserved areas."

I think the dynamic process that Congress established is particularly useful, because it gives all of us -- the companies, HUD and the Congress -- the opportunity to learn how to focus our business activities, and their regulation, most effectively. Furthermore, the process recognizes that the demands and conditions of the housing market are always changing.

I would like to give you a progress report on our work to date. I am very pleased to tell you that we will substantially exceed the goal that 30 percent of our business benefit families with low- and moderate-incomes. In 1993, we project that 34 percent of our conventional business will help finance homes for nearly 1 million families with low- and moderate-incomes -- about 220,000 more than we served in 1992.

We also believe we are well on our way to meeting our special affordable housing goal. There is more uncertainty in this area because the final regulations issued by HUD in October included some significant changes from the draft regulations concerning counting conventions and exclusions. In particular, the new regulations require us to recalculate the 1992 baseline from which we will measure the $2 billion goal.

I'm also happy to report that we have made very significant progress in our effort to provide additional financing in central cities in 1993. We project that approximately 840,000 families living in central cities will be served this year, an increase of about 180,000 families over 1992. Mr. Chairman, we can't be sure at this time if we will meet the 1993 regulatory goal of 28 percent, but we know that we are very close.

There are several reasons why we aren't yet sure what our final central city percentage will be. First, calculation of the percentage depends on the total business volume for the year; that number is driven by a refinancing boom which is continuing today. Since refinancing is less prevalent in central cities, the year-end business totals for suburban and other areas will have a large impact on the percentage. Second, we didn't know the exact components of the goal we have been shooting for until HUD issued the counting conventions in October. And third, the final HUD regulations require us to use a 1993 list of central cities, a change from the draft regulations, which permitted the use of a list in effect earlier. We have had to ask the Census Bureau to produce a new tape that will enable us to figure out how to allocate purchases from census tracts that straddle the borders of the central cities on this revised list; until next month, when we expect to receive the tape from the Census Bureau, we cannot score our central city purchases.

While it is not a legislated percent of business goal, I would also like to report to you on our financing activity for minority families. In 1993 we project that over 13 percent of our conventional single-family business will serve more than 320,000 minority households, an increase of more than 73,000 over 1992.

Based on our "Opening Doors to Affordable Housing" experience, and now a year of operating under the new housing goals, we've learned a number of important lessons.

First, in outreach efforts, we've learned that there is an enormous hunger for information about home buying opportunities -- particularly among lower income and minority families for whom the process is too often a mystery.

Second, we've learned that information can be power -- people will act on what they know and move through the door of homeownership when it is opened to them.

Third, we've learned that working directly with cities can leverage our resources and theirs, and make it easier for each of us to reach underserved communities.

Fourth, we've learned that the new data collection requirements in the Act bring great benefits. The additional data we're gathering from lenders about the families for whom we are financing loans will help us determine how to better reach them in the future.

Fifth, our experience so far with the percentage of business goals may have revealed some of the weaknesses of relying too much on them as precise measures of affordable housing service. Perhaps the most basic problem is that we have to measure the targeted group (the numerator of the percentage) against a volume of total business (the denominator) that is unknown and highly variable. This year's refinancing waves provide a stark example of how easy it is for our targeted business efforts to be thrown off by other market demands that are also important for American home buyers and the economy as a whole.

As we learn from the experience of the transitional period that Congress established, it may be advisable to consider focusing on other measures of our activity -- such as year-over-year comparisons, a rolling average, or the absolute numbers of households served in the targeted group. We may also want to focus on qualitative efforts that are highly important for certain groups or locations but which do not rack up big numbers, like programs that focus on specific geographic areas, population groups, or people with special needs. It would be unfortunate, in my view, if strict percentage of business goals force us into a measurement straightjacket that limits our incentives to serve as many low-, moderate-, and middle-income Americans as possible in as many ways as possible.

Sixth, as we try to expand our housing impact we've learned that we must, of course, take into account the important role that the Federal Housing Administration plays. The limitation on the size of the mortgages Fannie Mae can purchase and the effect of income and central cities housing goals mean that we are often seeking to serve many of the same families that FHA has traditionally served.

We would like to develop a more effective partnership with FHA to serve low- and moderate-income families, particularly in central cities. We have been working with FHA on a risk sharing program for multifamily projects as called for by the Congress. We have also had discussions concerning extending the risk sharing concept to single-family loans. We believe that significant benefits can accrue to low- and moderate-income borrowers if the efficiencies and risk taking abilities of the conventional market can be married with the credit support of FHA. Any examination of the future of the housing goals should take explicit account of the role of FHA in serving low- and moderate-income families in central cities.

Mr. Chairman, I'd also like to share with you today some additional exciting initiatives that we believe will provide breakthroughs in housing finance to make the system work better for all Americans. These are steps that go far beyond what we must do to meet the legislative goals.

I referred earlier to the aggressive "outreach" campaign we have underway, to educate consumers and help put them on a path to homeownership. We believe there are millions of consumers who are able to afford a mortgage and want to own a home, but have not yet done so. We are very committed to reaching out to those people and providing them with the information, counseling, and help they need to achieve homeownership.

Our technology innovations are another example. We believe that inadequate attention has been given to the impact of closing costs as a barrier to homeownership. Last year homeowners paid $27 billion in finance-related closing costs for an average of $3,000 each. These costs include mortgage origination, title search and insurance, mortgage insurance, and settlement charges. A $1,000 reduction in these costs at the closing table would have saved Fannie Mae's low- and moderate-income borrowers $1 billion this year. That's the equivalent of a $1 billion homeowner's assistance program. Looked at another way, it would be the same as a 20 percent reduction in the amount of money a first time home buyer would need for a minimum down payment on a house with a 95 percent mortgage.

Fannie Mae is committed to reducing this barrier to mortgage credit by reducing closing costs by at least $1,000. We believe that the introduction of new technology into the mortgage finance industry will help cut costs and therefore reduce closing charges.

We have begun by streamlining the process by which mortgage lenders do business with the secondary market. We have eliminated millions of pages of paper through our Mornet electronic connection to over 2,800 lenders. Our new Desktop Trader allows customers to do billions of dollars of transactions with us through their desktop computer without the need to talk to anyone at Fannie Mae and without generating any paperwork.

We are also working on technologies that will reduce the cost of originating mortgages. We are developing systems to cut the cost to process mortgage applications, called the Originator's Assistant, and to cut the cost of underwriting through our Desktop Underwriter. We are working on other industry innovations that will cut costs such as electronic data interchange standards, a mortgage document clearinghouse, and improved cash management mechanisms.

We have also supported efforts by others in the industry to reduce costs for home buyers. In particular, we have supported the efforts of the mortgage insurance industry to reduce the amount of the mortgage insurance premium due at the closing table. And we will encourage others to reexamine practices that burden homeownership by increasing closing costs.

Our investments in technology are very important to our ability to respond to the reality of a rapidly changing and very competitive marketplace. We strongly believe they will increase access to mortgage credit for thousands of low- and moderate-income families. I would be delighted if at the appropriate time in the future we could arrange a demonstration of our new technologies for the Committee.

We also look forward to working closely with our new regulator, the Director of the Office of Federal Housing Enterprises Oversight, Aida Alvarez. This Committee has had a significant, positive impact on Fannie Mae by modernizing our capital standards and our regulatory structure. We look forward to a positive and productive relationship with our regulator, and to working with her as she assembles her team and develops a risk-based capital standard.

Mr. Chairman, I know you and the members of this Committee share our excitement about all these initiatives, and the remarkable impact they can have on breaking down the barriers to homeownership and affordable housing posed by discrimination, cost, and lack of information. We will continue to work with Congress, with HUD, and with any partner who shares our commitment to making the housing finance system work for all Americans.

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Thank you very much for the opportunity to appear before you and discuss Fannie Mae's strong commitment to affordable housing finance. I'd be happy to respond to your questions.

Statement of James A. Johnson
November 19, 1993
Response to question from Congressman Watt
(regarding refinancing)

Regarding our purchase of loans to minority families, as of the end of October 1993, 13.15 percent of our total purchases for 1993, or 235,839 loans, were made to minority families. Minority families refinanced at a slightly lower rate than non-minorities, accounting for 13.11 percent of our refinancings; loans to minority families constituted a larger portion, 13.22 percent, of our purchase money business.

Statement of James A. Johnson
November 19, 1993
Response to question from Congressman Watt
(regarding diversity of work force)

Fannie Mae has made workforce diversity a priority over the past five years. It is our goal to have a workforce that mirrors at all levels our society as a whole. As a result, representation of minorities and women in management positions now approaches their proportion in the general population. The changes in the composition of our workforce over the last five years indicate significant progress. Among directors, who are the front-line managers responsible for running all aspects of the Company's operations, in 1988 minorities held 6.5 percent of the positions and women 34 percent. As of November 19,1993, minorities at the director level increased to 19.3 percent and women increased to 39.3 percent. This pattern is repeated among the officers of the company. In 1988, 5 percent of our officers were minorities and 25 percent of our officers were female. As of November 19, 1993, minorities comprise 11.7 percent of the total number of officers and women comprise 33.3 percent of the total.

(MR. JOHNSON)

FANNIE MAE INTERNATIONAL ACTIVITIES

Fannie Mae constantly seeks innovative ways to fund housing for American families. Among these innovations, Fannie Mae engages in overseas initiatives to support its funding of domestic housing finance. These international activities focus on two areas: raising funds through marketing debt, equity and mortgage-backed securities to international investors; and providing advisory services to sovereign nations.

Fannie Mae's international financial marketing strategy was developed to supplement Fannie Mae's domestic efforts to supply capital financing for the nation's housing activities. Fannie Mae's international financial marketing strategy helps Fannie Mae fulfill its congressionally established mission to provide affordable housing finance to low-, moderate-, and middle-income Americans.

Fannie Mae International Marketing Activities

Prior to 1984, Fannie Mae officials traveled overseas periodically to discuss funding opportunities with key investors. Fannie Mae's Chairman and CEO and its Chief Financial Officer have made annual trips to Europe and Asia, since 1984 and 1985 respectively, to meet with investors and government officials.

These international marketing efforts, which supplement efforts to raise capital in the domestic markets, result in increased demand for the Company's debt and mortgage-related products, both of which benefit American consumers. International investment in Fannie Mae debt obligations increases liquidity in the American mortgage finance system. Increased liquidity lowers Fannie Mae's debt costs, and those reduced costs are passed on to the American homeowner in the form of lower mortgage interest rates. Similarly, international investment in Fannie Mae mortgage-backed securities increases the supply of capital financing available for United States housing activities, which holds down the cost of domestic housing finance.

Fannie Mae International Advisory Services

Fannie Mae's contribution to the integrity, efficiency and effectiveness of the U.S. housing finance system also makes it the starting point for virtually all serious research on housing finance. As more countries strive to increase the affordability and availability of housing to larger segments of their populations, they look to Fannie Mae's experience as a guide in developing a housing finance system based on efficient market mechanisms and insulated from political risk. Fannie Mae's contribution to the affordability and availability of housing for millions of Americans over 56 years is a compelling model for many foreign nations seeking to develop their own private housing finance facilities.

Fannie Mae has received requests for advice and information about housing finance from foreign governments, international organizations, Congressional offices, and the Executive Branch. These requests have increased in the last few years due to the greater awareness of Fannie Mae in the international community, and to an expanded emphasis by the Department of State, the Treasury, the Department of Housing and Urban Development, the Department of Commerce, the Agency for International Development (AID), and the Congress on using private companies to supply technical assistance to foreign countries. The Executive Branch is also seeking to involve U.S. firms in order to increase opportunity for American investors and expand trade. Many Fannie Mae projects were initiated at the request of Congressional or Executive Branch officials.

In 1990, Fannie Mae formalized its international counseling program by creating a small, self-sustaining unit offering housing advisory services to international organizations and foreign countries. In almost all cases, the services are funded directly or indirectly by either the United States Government (through AID) or by international development agencies such as The World Bank. AID administers U.S. economic assistance programs that promote America's national interests: building democracies, encouraging free market economics, fostering development, and increasing humanitarian support. The World Bank promotes economic and social progress in developing nations by lending funds, providing advice, and serving as a catalyst to stimulate outside investments. The World Bank's resources come primarily from funds raised in the world capital markets, its retained earnings, and repayments on its loans. The United States is the largest subscriber to the World Bank.

Fannie Mae's approach to advisory assistance marries the Company's capabilities with the needs of the entity making the request; the form of assistance varies with each project, and new forms are constantly being considered. Completed international advisory projects include training in Russia, seminars in France, Portugal, Morocco and Taiwan, a feasibility study in Turkey and program design in Israel. Closer to home, Fannie Mae has provided an evaluation study for Argentina and strategic analysis of major issues in Mexico. Ongoing Fannie Mae international advisory programs in Eastern Europe offer advice, program development, strategic development, operational implementation and training to create and market housing finance systems in Poland, Hungary, Bulgaria, and the Czech and Slovak Republics. Projects in a number of other countries, including Australia, India and the Philippines, are under active consideration. In Washington, Fannie Mae offers seminars and on-going advisory services on a short-term basis to officials from countries including Australia, Austria, Belgium, China, Colombia, Costa Rica, Finland, Ghana, India, Indonesia, Japan, Jamaica, Kenya, Korea, Malaysia, Nigeria, Pakistan, Singapore, Spain, South Africa, Sweden, Switzerland, Thailand, the United Kingdom, and Zimbabwe. The goal of all these projects is to strengthen social and economic systems through greater affordability and availability of housing; the means is the creation or enhancement of market-oriented private housing finance systems.

Fannie Mae believes that its modest foreign advisory services have helped promote U.S. Government objectives. In a small but practical way, Fannie Mae has helped to expand support for market economies and democracy by fostering concrete projects that help average citizens. In many of these nations, governments are striving to demonstrate that democracy can deliver the "goods" as well as freedom. Housing is particularly important because it helps supply the "social infrastructure" for economic reformers; it helps develop property holders with an interest in reforms. Available housing is critical for labor mobility as old, inefficient plants close down and new jobs are created in different locations.

The heightened international profile afforded Fannie Mae by these advisory activities has contributed to the effectiveness of its efforts to generate funding overseas to support domestic housing. Fannie Mae's international activities are important components of its success in reducing costs, handling extraordinary volumes, and increasing availability of housing for American families.

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Laredo National investors seeking Mexican charter

By SANDRA LOWE

Some Mexican investors in Laredo National Bank are seeking regulatory approval to charter a new bank in Mexico, according to Gary Jacobs, president of the Laredo-based bank.

Jacobs says that some of the same owners of the Laredo bank are raising $100 million in new capital to charter Banco Interacciones, a bank which will focus on housing and Mexico's infrastructure. The bank is expected to open in March.

Jacobs declined to name the investors. Laredo National Bank is privately held.

In a separate development, some of Laredo National Bank's Mexican investors are buying out their European investors. Jacobs says that those acquiring additional stock already have an interest in the bank, and the acquisition will not change who controls the bank. "The same control group still controls Laredo (National Bank)," he says. However, the acquisition by Mexican investors increases the bank's ties with Mexico. "It gives us a much more focused strategic plan with Mexico," Jacobs says.

According to the Federal Reserve Bank of Dallas, Carlos Hank Rhon of Lomas Virreyes, Mexico, has applied to acquire controlling interest in Laredo National Bancshares Inc. The holding company owns Laredo National Bank and South Texas National Bank of Laredo.

Incus Co. Ltd. and Kline Investment Co. Ltd., both of Tortola in the British Virgin Islands, have applied to acquire more additional shares in the holding company, according to the Federal Reserve. A spokesman for the Federal Reserve declined to name the owners of the two Virgin Island entities.

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Window of opportunity

Mexico seeks Fannie Mae to help develop its young housing market

By SANDRA LOWE

There's an opportunity emerging in Mexico that could turn into a jewel for some U.S. mortgage and investment companies — the housing market.

Mexico's government plans to introduce legislation within the next month to operate a secondary market in its country. And the government is seeking the United States' most experienced secondary market provider, Fannie Mae, as a partner.

"They have the experience. We don't," Antonio Gonzalez Karg, director general for housing finance in Mexico, says about the Federal National Mortgage Association (Fannie Mae). "We want to follow in their steps. We want to learn from their mistakes."

While no decisions have been finalized, Gonzalez Karg says several options are under discussion. One is an investment to be made by Fannie Mae in the entity the government would charter to operate the secondary market. Whatever its role, Gonzalez Karg says that Mexico would like Fannie Mae to have some degree of input. "The important thing is to have them on our board," he says.

For its part, Fannie Mae officials would only say they are in frequent contact with the Mexican government about a secondary market operation. "We are very, very flattered and very appreciative that they came to the conclusion that the people to learn from was Fannie Mae," says Beth Marcus, managing director of international housing finance services. "We have let them know we'd be happy to be of assistance to them."

Industry officials speculate that Fannie Mae is very interested in an active role in Mexico. However, it is likely examining its charter to determine what role it can have. Marcus says that the company, which was chartered by the federal government in 1938, has no plans itself to buy and sell Mexican loans. Nor is it considering a charter change.

Whatever role ultimately develops, Fannie Mae's experience in mortgage lending far outpaces Mexico's. The company, which has a more than $2 billion unused line of credit from the federal government, buys loans from mortgage lenders, pools and securitizes them, and sells them to investors.

Fannie Mae has $192 billion in assets and $465 billion in mortgage-backed securities outstanding.

But analysts and observers say that Mexico's housing market could be like a goldmine compared to the United States. "We have a relatively mature housing market," says Gary Jacobs, president of Laredo National Bank. "Here's a neighbor where there's 25 years of growth."

In fact, according to a copyrighted story by *Bloomberg Business News* of New York, analysts say Mexico is short 6 million dwellings. Moreover, the story says analysts estimate that while mortgage loans represent 68 percent of the U.S. gross domestic product, they only represent 5.4 percent of Mexico's.

For U.S. lenders, many of them which currently deal with Fannie Mae, it is a potential new field of business — consulting. Some lenders, like BancPlus Mortgage Corp., are eyeing those opportunities as potential money-makers when local markets run dry.

"At some point, even if rates (in the U.S.) stay where they are, we're going to have to look to other areas for growth," says John McMurray, senior vice president at BancPlus. "(Mexico's) very much an emerging market."

Such opportunities have occurred without direct investments from Fannie Mae.

The passage of the North American Free Trade Agreement would also likely enhance opportunities, since more U.S. companies could set up operations in Mexico. But even now, Mexican lenders are pursuing the mortgage market, with some increased benefits to U.S. companies.

Some Mexican investors who hold an interest in Laredo National Bank have applied for a new bank charter in Mexico. Jacobs says that the Mexican bank plans on focusing its lending efforts on housing and infrastructure, which could ultimately increase opportunities for the U.S. bank.

For years, lack of lendable funds and high inflation rates meant that the only Mexicans who could buy homes, for the most part, were those who could pay cash. "The market was essentially non-existent," says Richard Bello, an analyst with Morgan Stanley & Co. of New York.

But Gonzalez Karg says that this year inflation rates are expected to be about 9 percent, down from a high above 100 percent. Interest rates on mortgages are running at about 19 percent. The government is trying to get inflation down to 5 percent next year, when the secondary market structure would begin operation.

With 5 percent inflation, Gonzalez Karg says a secondary market should work, both for consumers and for investors, providing more securities on the market and utilizing more capital.

But some industry observers say a successful development of a secondary market may not be so easy. Culturally, people are uncomfortable with consumer credit. Because Mexico's inflation reached such high levels, few people want to borrow long-term on variable rates. But investors fear getting locked into long-term rates. "The concept of long-term lending just doesn't exist in Mexico today," says John Kauth, a partner in Intercontinental Asset Management Group Ltd., a San Antonio-based investment firm.

But Bello says that is changing. One of Mexico's banks, Grupo Financiero Serfin recently launched a fixed-rate mortgage product. The government also recently extended the term of its treasury bond, the CETE, to two years. Bello says that the securities industry believes that the country will continue to reduce its inflation, reducing interest rates and extending its investment terms. "It's going to take some time," he says.

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Kitchen-Sink Bonds May Offer Everything but Stability

By LAURA JERESKI
Staff Reporter of THE WALL STREET JOURNAL

There they go again.

Wall Streeters have figured out a new way to turn explosive securities into tame-looking investments. Once again, banks are the targeted buyers. But regulators fear the bonds' future may prove stormier than buyers expect.

Banks and other financial institutions have bought more than $3.5 billion of them since April. The offerings are called secured investor trusts but known on the Street as "kitchen-sink bonds," because they are backed by everything but.

For securities firms and some of their clients, kitchen-sinkers are a godsend. The bonds are issued by trusts into which Wall Street dumps bits and pieces of capricious, hard-to-value mortgage-backed securities. If the market for a certain mercurial mortgage-backed bond should dry up, just pop it into a trust and get it off the investors' books.

Yet even the bonds' admirers aren't without qualms. Michael May, vice president of the Federal Home Mortgage Loan Corp., which issues mortgage-backed securities and has been considering issuing this type, concedes: "Some days I feel just fine; some days they make me nervous as hell."

Kitchen-sinkers are the offspring of mortgage-backed securities, which are backed by the interest and principal payments from pools of mortgage loans. Wall Street carves up the cash flows from those securities into quirkier bonds, known as collateralized mortgage obligations, or CMOs. There are more than $800 billion of CMOs on the market.

A More Palatable Mix

The problem is, a few CMOs are just too weird for investors to digest. These CMOs may languish in the inventories of Wall Street firms that underwrite CMOs or on the books of customers, posing risks. Kitchen-sinkers are the latest way Wall Street gussies up mercurial bonds and passes them on to other investors. The idea is to lump lots of the unpalatable CMOs into another diversified pool, then re-cut the underlying cash flow into pieces that appear more appetizing.

"To the extent that this creates demand for more esoteric [CMOs], the deals will improve the market overall," says Mr. May of Freddie Mac.

Because kitchen-sinkers carry triple-A ratings from credit-rating services, their risks aren't obvious. The top-notch rating, from Fitch Investors Service Inc. and Duff & Phelps Credit Rating Co., reflects how the deals were structured, not the underlying assets' safety.

The bonds will boast the triple-A rating as long as the underlying securities throw off enough cash to pay investors as promised, a structure known as a cash-flow bond. Never mind it's a slight promise: to repay investors their principal at the trusts' expiration in some 30 years. What lures investors is the two percentage points above floating short-term rates they will get if the bonds work out.

Marketability Questioned

And what if they don't? Federal regulators and even critics on Wall Street worry that the bonds are too complex to analyze and may be unsalable as a result. The trusts contain pieces of dozens of mortgage deals — some privately placed — from as many as a dozen underwriters.

"Our concern with this product is the purchaser's ability to test the volatility of the securities," says William A. Stark, assistant director of the office of capital markets at the Federal Deposit Insurance Corp., which insures bank deposits. The Office of Thrift Supervision has determined that the bonds are high-risk holdings, which means the thrifts holding them would have to mark them to market prices.

Earlier this fall, mortgage prepayments reached record levels as interest rates fell and homeowners rushed to refi-

nance at lower rates. That drove down the price of CMOs whose returns rely solely on interest – not principal – payments on the underlying mortgages. such bonds suffer when mortgage prepayments rise because it means the interest payments earmarked for them are cut off early.

Insurance companies feeling the heat of new regulations wanted to dump such interest-only bonds as IOs and PAC IOs, or planned amortization class, a structure intended to be more stable. When no one wanted them, the sellers couldn't get an acceptable price.

Spurred by Banks' Demand

Wall Street firms created the kitchen-sink trusts to seize on the profit opportunity created by matching up the poor-selling IOs with banks' ravenous appetite for floating-rate bonds. Bear, Stearns & Co. has issued nearly $2.5 billion since April, reaping at least $25 million in profit and savings.

Banks are especially enamored of floating-rate mortgage-backed bonds because they are exempt from stringent new rules intended to monitor the "interest-rate sensitivity" of banks' portfolios. The rules restrict bank investments in the most volatile mortgage-backed securities, but that has barely damped banks' appetites

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High-Risk Securities Find a New Home In Kitchen-Sinkers

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for bonds that can match their short-term liabilities. Holdings of CMOs by the 100 largest banks nearly tripled to $90 billion in the first half of 1993, according to Inside Mortgage Securities, a newsletter.

The Wall Street firms putting these deals together insist that the trusts provide a resale market for hard-to-analyze bonds that are prone to falling out of favor. "If there isn't a bid in the market," says one deal designer, "at least you can get the bonds off your books."

Increasingly, however, underwriters are using the trusts to absorb the risky remnants of new issues, which must be sold in order to sell the rest of the deal.

Case in point: the $263 million kitchen-sinker sold last month by Bear Stearns. The trust contains pieces of 28 mortgage-backed deals from nine underwriters and is replete with such esoterica as inverse two-tiered index bonds, which are capped bonds that float inversely to a popular interest-rate index.

About $85 million of the bonds came from Bear Stearns' inventory, including inverse two-tiered index bonds, IOs and inverse floaters, which pay less as rates rise. The rest were created by dealers at General Electric Co.'s Kidder, Peabody & Co. unit, Lehman Brothers, Merrill Lynch & Co., Salomon Brothers Inc., First Boston Corp., Goldman Sachs, and Donaldson, Lufkin & Jenrette Securities Corp.

Many of the bonds in the trust are less than six months old and may never have been sold out of the dealers' inventory before being absorbed in the trust. Yet there isn't any disclosure about where the bonds came from, or who underwrote them, in documents filed with the Securities and Exchange Commission. There isn't information about the price at which the bonds were contributed to the trust nor the valuation method Bear Stearns used.

Such disclosure would be required for a bond underwriting or a public sale of stock. But it is absent here because the securities in the trust – CMOs backed by mortgages with credit guarantees from Freddie Mac and the Federal National Mortgage Association – are deemed to be securities issued by government-sponsored entities exempt from disclosure requirements of the Securities Act of 1933.

A Bear Stearns official said it placed bonds in the trusts when their cash flows were needed to make the deal work or the trusts provided the best price.

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